

'Story' Bonds More Abundant in Munis

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George Strickland, managing director and co-portfolio manager of the Thornburg Municipal Bond Strategies, answers our questions on recent opportunities, laddering, and credit quality in the Thornburg Limited Term Muni Bond Fund (LTMFX).

1. With the strong returns of muni funds in 2009, one would think that it's smooth sailing ahead. Yet, many municipalities are experiencing lower revenue collection and rising indebtedness. Is there a disconnect investors should be concerned about?

To tell you the truth, there is a disconnect. This time last year, when municipal finances were arguably in much better shape, very few people would touch municipal bonds. Now, the muni market (and corporate bond market) is the hot place to be, yet the fiscal situation is much worse. Are we too popular now or were we too unpopular then? I would say more the latter. Top-quality tax-free municipal bonds should never have traded at 200% of Treasury bond yields, but I am still finding good bonds at cheap prices. There are, however, plenty of bad bonds at expensive prices around these days. Investors should be more careful than ever, both on the credit front and the pricing front. We are building in some pretty awful revenue scenarios before we are willing to buy bonds these days, because we think municipal cash flows are going to keep getting worse for a few more quarters. The good news is that, even under these dire scenarios, a lot of bonds still make the grade.

2. Did last year's events, particularly the reduction of liquidity in the muni markets, have any impact on how you're going to manage the fund going forward?

We really haven't changed our style very much at all. What has changed is the size of the opportunities that we have to add value. We've always spent a lot of time looking for good quality bonds that may be a little hard to understand—story bonds that aren't novels. We blend these in with more generic bonds to make a well-structured portfolio. Prior to 2008, we had to work very hard to pick up 50 or 100 basis points on story bonds. The bond insurers, hedge funds, and prop

desks would scoop them up and leverage them before they got any wider. Now, with those players out of the picture, we can get paid two to three times as much spread for the same work we've always done. Consequently, we are somewhat more weighted toward story bonds these days than we were a couple of years ago. We also opened up a new fund—the Thornburg Strategic Municipal Income Fund (TSSAX)—to take advantage of the new environment by concentrating its portfolio in story bonds.

3. What's the advantage in laddering the Limited Term Municipal Fund portfolio in the manner you do?

We use laddering as our yield curve management tool. By spreading our maturities out fairly evenly over 10 years in our limited term funds and 17 years in our intermediate funds, we get exposure to different parts of the yield curve. As time goes by, the bonds age and slide down the ladder toward maturity. This does two things. First, it allows us to replace older maturing bonds at the top of the ladder where yields are higher. The idea is that, over time, you have a portfolio with the yield of the top of the ladder, but the duration risk of the middle of the ladder. Second, as bonds age and roll down the steep part of the yield curve toward maturity, they get priced at lower and lower yields. Since lower yield means higher prices, this phenomenon can provide a pretty good tailwind to a fund's total return performance. The final reason for laddering a portfolio is to spread out reinvestment risk. A number of funds forgot this a year ago when they were grabbing for the most yield they could get at that time. What good is a 7% yield if you only get it for a couple of months, particularly if you put principal at risk to get it? We will often give up some absolute yield in order to get durability of yield.

4. Are you increasing or decreasing the fund's exposure to mid-quality bonds (bonds rated A and BBB)?

Earlier this year, we increased the fund's exposure to mid-quality bonds to a level that we haven't reached since the mid-1990s, shortly after I started working on the fund. We have now started to gradually

reduce the exposure to mid-quality bonds. We are doing this very slowly because credit spreads are still very wide and some of those mid-quality bonds are really pretty solid, but the opportunities aren't nearly as widespread as they were earlier in the year.

5. What's a recent example of a bond you've purchased that best highlights your research capabilities/advantages?

There are many, but one of my favorite recent purchases is a Santa Margarita/Dana Point Authority Revenue bond. The bond was issued in 1997 with AMBAC insurance, which is now more or less worthless. The underlying credit was only rated by Moody's and it was rated only Baa3. However, the authority had recently issued an almost identical bond that was rated AA by Standard & Poor's. Once I dug through the documents, I saw that it was really a general obligation bond with an enormous tax base (have you ever been to Dana Point, Calif.?). I'm guessing Moody's just hadn't caught up with the last dozen years of development. Anyway, we were able to buy the bond at a 5.75% yield to its 2018 maturity for a spread of 300 basis points. Best of all, we were able to buy it in enough size to move the performance needle in a positive way.

Important Disclosure Information

The views expressed by George Strickland reflect his professional opinions and are subject to change. Securities mentioned are presented to illustrate companies in which the fund has invested. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy or sell securities.

Investments in the Funds carry risks, including possible loss of principal. Bond funds have the same interest rate, inflation, and credit risks that are associated with the underlying bonds. The principal value of bond funds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. This effect is more pronounced for longer term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Investments in lower rated and unrated bonds may be more sensitive to default, downgrades, and market volatility; these investments may also be less liquid than higher rated bonds. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Investments in the Funds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

The laddering strategy does not assure or guarantee better performance than a non-laddered portfolio and cannot eliminate the risk of investment losses.

Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor or visit thornburg.com. Read it carefully before investing.

Basis Point – A unit equal to 1/100th of 1%. 1% = 100 basis points (bps)

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