Miller Tabak Asset Management
Second Quarter Review and Commentary

Tax-free bonds performed admirably over the past three months, posting positive returns despite some significant global turbulence. Once again, it was investors who ventured further out along the yield curve that were rewarded the most. When looking at overall returns over the past twelve months, it is quite stunning to see that one-year municipals have lagged ten-year municipal returns by a whopping nine percentage points!

There are many plausible explanations for the consistent outperformance of longer-dated municipals (Fed holding rates at zero, fear of tax-exemption going away, ongoing concerns of a global recession, etc.), but from our perspective, both individual investors and financial advisors consistently have underappreciated reinvestment risk. The usual refrain we hear when speaking with market participants is "when rates go higher…" — which tells us intuitively that the market is chronically underweight their benchmarks and overweight cash. Our central investing theme continues to be that interest rates will be historically low for much longer than many expect. This will prove devastating to savers, pension plans, and to fixed-income money managers, who will find downward pressure on management fees a disruption to their business models.

Right now, municipal issuers are exerting their share of pain on bondholders by redeeming, or "calling away," higher coupon bonds at a record speed. This is throwing tax-free bond investors into a somewhat catatonic state as they have seen income levels downgraded in their portfolios just as interest rates reach generational lows. This is an easily underappreciated "mega" trend that can continue to exert downward pressure on interest rates long after the economy recovers.

A Young Child Rides a Bike in San Francisco

Speaking of the economy, it is clear to many that the world is seeing a retrenchment in growth (downward) due to the massive de-leveraging underway in Europe. Fiscal and monetary spigots are once again in focus by investors looking to front run any "risk" rally, as hopes of a recovery spring eternal. Miller Tabak Asset Management fears a "liquidity trap" is maturing globally that will cause economies to sink again once a small removal of either fiscal or monetary stimulus becomes necessary. Picture the dilemma in your mind of taking a child for a bike ride in beautiful San Francisco. There is an adrenaline rush of zooming down a steep hill, only to find that once the bottom is reached, there is no feasible chance of peddling back up that hill. The global economy now sits at the bottom of the hill, looking for different "avenues" to get back "home." What if the only "cable car" economy—China—that could push the global economy up the hill again begins to move in reverse, as well?

"BATBB" to Stay in Place

As mentioned in our last quarterly commentary, we continue to see value in taking the "BATBB" approach to investing in municipal bonds. There will most certainly be periods in the coming weeks where upward pressure on interest rates will be at hand. Miller Tabak Asset Management prefers to deploy cash in this environment, and we will focus on the secondary market where bids tend to "gap down" almost immediately these days. The beauty of the municipal bond market is its illiquidity. Sophisticated investors know this can be exploited when the market is under pressure—we remain on high alert for this opportunity to arise.

Health Care, the Supreme Court, and Munis

Now that some clarity has emerged on the health-care law thanks to the Supreme Court's decision to uphold a majority of the legislation, it makes sense to now consider how it gets paid for. We focused immediately on the 3.8% tax on "unearned income" for married couples earning more than $250,000 and individuals earning at least $200,000. Wealthy investors could seek out municipal bonds in greater numbers to help shield income from this surcharge, levy, or tax (we are not exactly sure how to classify it—but you get the point). When considering the possible end of the Bush tax cuts in December of this year, a reasonable investor could conclude that tax-free municipal bond demand can remain buoyant because of this possibility. Should the tax-exemption enjoyed by municipal bonds be put in jeopardy by Congress and the President to help pay for the staggering federal deficit, then "buoyant" demand might better be described as "insatiable." Our best guess would be that any movement to curb the tax-free exemption on municipal bonds would only pertain to those being issued in the future. Bonds currently "tax-free" would be "grandfathered" in our view, and as such would become museum pieces that would trade only upon appointment. This would be undeniably positive for tax-free bond prices, and would absolutely enter more "reinvestment risk" into millions of portfolios.

Moving forward, it can become a more difficult environment for municipal bond credit quality if the global slowdown becomes more pronounced. Investors who utilize the services of Miller Tabak Asset Management should continue to expect zero-tolerance for any loss of capital on bonds we purchase due to issuer insolvency. The federal deficit in the United States should remind everyone that more fiscal pain is coming down the road for states, cities, and counties who will have to remain lean to stay above water in this slow growth environment. Professional municipal bond management is essential for conservative investors as far as the eye can see for that reason.

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