

Q&A

November 2006

John Cummings Discusses the High Yield Municipal Bond Market

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Mr. Cummings is a Senior Vice President and portfolio manager within PIMCO's municipal bond team. He joined PIMCO in 2002, previously having been associated with Goldman Sachs as vice president of municipal trading where he was responsible for a number of municipal sectors, including industrials, airlines, utilities, healthcare and high yield. Mr. Cummings has over twenty-two years of investment experience and holds a bachelor's degree in economics and an MBA in finance from Rutgers University.

John Cummings is a portfolio manager and a veteran trader in the municipal bond market. In the interview below, Mr. Cummings discusses the basics of the high yield muni market and the issues that investors face in their approach to high yield munis.

Q: John, can you give us a brief description of the high yield municipal bond market?

Cummings: High yield municipal bonds are typically issued to finance economic or industrial development, housing, environmental projects, and health and retirement care facilities. Like other areas of the municipal bond market, interest payments on high yield munis are typically exempt from federal taxes, and in some cases, state taxes. This tax benefit, combined with low default rates relative to corporate bonds with similar credit ratings has been a major draw for tax-paying investors that are focused on income.

As the name implies, high yield muni bonds are at the lower end of the municipal credit spectrum. About 55% of high yield muni bonds are actually unrated, but those that are rated carry an average credit rating of B2. Because of the below-investment grade nature of these bonds and variability of bond structures and projects, high yield munis are truly a professional's market, with a heavy burden on due diligence and in-depth credit analysis that comes in exchange for potentially higher returns.

A large number of high yield muni bonds are issued to finance healthcare facilities, like hospitals and nursing homes, or land deals which finance infrastructure ahead of new development. Other high yield munis are issued to finance such things as airport terminals, environmental remediation, charter schools and projects related to utilities.

The high yield muni market has grown quickly in recent years due to low borrowing rates, robust residential real estate investment, environmental legislation and demographic changes requiring increased medical care and retirement facilities. Higher issuance has come alongside heavy demand from investors looking for tax relief and income opportunities in a low return environment for stocks and bonds.

Typically, the debt is issued by a government unit, which in turn makes a loan to a non-profit borrower under section 501(c)(3) of the federal tax code. Coupon and principal payments are usually supported by a special tax or revenue from the project, and can be additionally secured by mortgages or liens on the project's hard assets. High yield munis

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may also be issued to finance private projects that benefit the community, such as for waste remediation, airline terminals or public utilities. In those cases, the debt is backed and paid for by a corporation.

Q: For investors, what are the benefits of high yield municipal bonds and what are the risks?

Cummings: The primary benefit of high yield municipals is attractive income that is typically exempt from federal income tax, and in some cases, state income tax. Because of that tax exemption, individuals make up the bulk of high yield muni investors but the bonds are broadly suitable for all tax-paying entities, including property and casualty insurers and corporations.

Because high yield munis are at the lower end of the sector's credit spectrum, they can offer substantially higher yields than higher-rated munis with less historical return volatility. Additionally, like all municipal bonds, high yield munis can also be an excellent way for investors to diversify their holdings.

High yield munis also offer the potential for capital appreciation. Projects financed in the high yield muni market typically have a speculative element to them – for example, they might finance the infrastructure for a new housing development or an airline terminal to meet projected travel demand. They can appreciate in value if the project's revenues prove to be stable over time. In that case, unrated bonds could become rated, rated bonds could be upgraded, or an issuer might refinance into a deal with better terms.

High yield munis have also generated higher after-tax returns than high yield corporate bonds with substantially lower historical default rates.

Still, investors should be aware of the risks inherent with high yield munis. Put simply, they are rated lower than investment-grade munis because their credit risk is higher. That puts an especially high burden of analysis on investors. High yield munis require a particularly robust "bottom up" approach to evaluating the specific developer, the demographics of the community where the project is being placed, project cash flows and the value of the collateral assets.

Q: You mentioned that high yield municipals offer potential diversification benefits. Can you elaborate?

Cummings: Beyond the tax advantage and the potentially enhanced yields, high yield munis can be an excellent diversification tool for investors looking to spread their risks. High yield munis, like investment grade munis, have a low correlation with many other asset classes, particularly equities. Over the ten years ending Sept. 30, 2006, high yield munis had a very low 15% correlation with the S&P 500, while high yield corporate bonds had a much higher 50% correlation.¹

The reason for the lack of correlation between high yield munis and stock and corporate bond markets is that high yield munis finance projects with less cyclical revenue streams and with hard assets as collateral. Hospitals, for example, typically don't see big shifts in

¹ Sectors represented by the Lehman High Yield Corporate Index and the Lehman High Yield Muni Index

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the number of patients treated over the course of an economic cycle. Corporate high yield debt, on the other hand, finances growth of companies and equity prices are dependent on that growth coming to fruition. There are many external risks to that growth - problems with cash flow, a slowdown in customer demand or a tightening among sources of additional credit - that can lead to a default. As a company approaches a distressed situation, its debt will behave more and more like equity since bondholders are often converted to equityholders in bankruptcy.

Q: How much lower have high yield muni default rates been compared to high yield corporate default rates?

Cummings: It's important to understand that default rates on high yield municipal bonds are distinctly lower than those of high yield corporate bonds, even ones with similar ratings. In fact, the difference in default rates is striking, according to a study by Moody's Investors Service looking at default rates on 10-year debt between 1970 and 2000. The average cumulative rolling 10 year default rate for speculative-grade munis was 1.93% for the period, compared to a 32.04% default rate for speculative grade corporate debt.

Another subtle, yet highly significant difference in the risk profile of high yield munis is that they don't have the same degree of leveraged buyout risk that many corporate bonds have. LBOs, in which companies are acquired with a large amount of borrowed money, can instantly hurt a company's credit rating by ratcheting up its levels of debt. These events can really cause havoc for holders of corporate bonds, particularly since many firms that are bought out are rated below investment grade to begin with. For projects financed by high yield munis, there is typically no equity owner, so you're not going to see the same type of releveraging events. Investors typically don't see LBO activity hit areas like housing infrastructure projects or retirement communities or charter schools.

Q: You mentioned that many deals are collateralized. What role does collateral play in selecting high yield munis?

Cummings: Since every high yield muni issue is different, it's very important for investors to know exactly where they fit into the capital structure. High yield munis have relatively high recovery rates versus similarly rated corporate bonds, but investors should be aware of the nature and quality of the collateral securing their bonds and how senior they are in the capital structure. In addition to carefully analyzing the revenue source and the issuer, PIMCO places a big emphasis on high yield munis that are at the top of the capital structure by focusing on secured debt versus unsecured debt.

When considering the capital structure and the collateral, investors must always ask the following types of questions: How hard will it be to find a new management for the hospital or turn the hospital into something else? Similarly, say a power plant issued high yield muni for a pollution control deal backed by a first mortgage lien on the plant. If there is a default, are investors going to foreclose on a power plant? Probably not, but in the event of a bankruptcy, you want to be the most senior, which puts you near the top of the food chain if assets are liquidated.

Q: Can portfolios of high yield municipal bonds be actively managed?

Cummings: With so many unrated issues and unique structures, the high yield muni market is clearly limited in liquidity, and trading often depends on research and

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negotiation rather than the fast-moving screen trading that occurs in markets such as Treasuries. For each separate issuer, it's important to note the quality of the underwriter, the call structure, tax-exemption specifics and the liquidity.

Yet there are opportunities to generate capital gains within a high yield muni portfolio by taking positions that reflect interest rate expectations, by seeking undervalued sectors or by targeting prepayment trends that can be driven by interest rate movements. As with all bond sectors, PIMCO employs a top-down secular view to identify attractive sectors, but an extensive amount of bottom-up credit analysis is also needed to determine which bonds have the most potential to add value. In general, we look for securities that have the potential to be upgraded, which causes the value of the bonds to rise. Additionally, PIMCO seeks to generate excess returns by entering positions that reflect our views on curve, duration, sectors and individual credits. It should be noted, however, that capital gains from trading municipal bonds may be subject to federal and sometimes state capital gains taxes.

Q: How does PIMCO approach the High Yield Muni Market? To what extent does the macro view of the economy play into credit selection?

Cummings: Credit selection in the municipal bond market is different than it is with other types of bonds. High yield munis require more project-specific - and thus issue-specific - analysis for the simple reason that every project is different.

With corporate bonds, macroeconomic factors can affect a whole sector. For example, the level of demand for autos will have an effect on all corporate bond issuers in the auto sector. But for high yield municipals, a hospital in one community might thrive while a hospital in another won't. As a result, the process of selecting high yield munis has a more rigorous bottom-up element. Additionally, muni investors tend to buy and hold these securities and so we don't necessarily see the same degree of sector rotation that we see in corporates.

However, the macro-economic view does play a role in determining which areas of the high yield muni market might add the most value. Given expectations for a slowing economy and risks to the housing market, PIMCO is becoming more defensive and conservative with its exposure to bonds supporting single-family housing developments. A housing slowdown may also affect retirement communities, since many people finance the entrance fees for retirement communities by selling their existing homes. We still find the sector attractive over the long term, but we are currently being very selective and choosing only those bonds with more conservative credit features.

Our basic approach is to be well-diversified among all sectors, but in general we will maintain higher quality than the average holdings of the Lehman Brothers High Yield Muni Index. We aim to identify those bonds that provide attractive yield with price appreciation potential and those projects that are likely to weather an economic slowdown.

Q: Thank you, John.

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Each sector of the bond market entails risk. An investment in high-yield securities generally involves greater risk to principal than an investment in higher-rated bonds. Municipals may realize gains and shareholders will incur a tax liability from time to time. Income from the portfolios that invest in them are subject to state and local taxes & may at times be subject to the alternative minimum tax. It's important to note that a portfolios concentrating in a single state is subject to greater risk of adverse economic conditions and regulatory changes than a portfolio with broader geographical diversification. Please consult your tax and/or legal counsel for specific tax questions and concerns.

The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio. Diversification does not ensure against loss. Duration is a measure of price sensitivity to interest rates and is expressed in years.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long-term, especially during periods of downturn in the market.

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