How are you adapting to a changing muni landscape?

A professionally managed, laddered approach to municipal bonds may make sense now.

SUMMARY

A professionally managed laddered municipal bond portfolio:

- Provides access to professional credit research and management.
- Uses institutional power to buy and sell bonds at advantageous prices.
- May be helpful in a rising interest-rate environment, providing predictable tax-exempt income.

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Individual investors and financial advisors building municipal (muni) bond portfolios on their own face several challenges in today’s environment. Factors such as heightened credit risk, limited access to bonds, large markups and potentially volatile interest rates have made investors reassess their muni strategy. Many of these “do-it-yourself” investors may also suffer from poor investment performance exacerbated by lingering uninvested cash balances. Going it alone in the muni market has become more risky and time-consuming for many.

At the same time, higher taxes have made tax-exempt interest income from muni bonds more compelling to investors. We think investors would be wise to examine their tax-exempt allocation and consider a professionally managed laddered approach to muni bonds.

**What is a laddered investment strategy?**

A laddered approach may provide the benefits of muni bonds – predictable, tax-exempt interest income and price performance that is relatively uncorrelated with equities – while also delivering the customization needed for an investor’s unique circumstances. Laddering a muni bond portfolio involves equally weighting maturity exposure over a specified portion of the yield curve. A constant percentage of bonds mature, or roll out, each year. When this occurs, the proceeds are reinvested on the longer end of the ladder. Exhibit A illustrates this concept in general terms.

**Use ladders to combat the threat of rising rates**

Equally weighted ladders may also be defensive in a rising rate environment. As shorter bonds roll out of the lower-ladder range, the proceeds may be reinvested at the higher-yielding upper-ladder range, assuming a positively sloped yield curve. This has the potential effect of raising the yield of the portfolio. The result can be positive income and total return even in rapidly rising rate environments.

Exhibit B on the following page expands on the reinvestment concept using the Eaton Vance Laddered Municipal Bond Interest Rate Scenario Tool (available at eatonvance.com/muniladder). This tool may help quantify a general range of potential returns based on interest-rate expectations going forward. In the example on the next page, the laddered portfolio experiences increases in estimated annual income and annual return, even as interest rates rise over the five-year period.

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**Exhibit A**

A laddered muni portfolio may allow investors to reinvest proceeds at higher rates.

Proceeds from bonds maturing in 2017 are reinvested at the long end of the ladder in 2025.

Source: Eaton Vance. This table is for illustrative purposes only.
This can be particularly helpful to investors who want to achieve an attractive total return regardless of the interest-rate environment, but want to avoid price and reinvestment risk. While there may be price fluctuations over time, matching maturities of the bonds to an investor's time horizon may help with the primary goal of capital preservation. In the event of price declines, investors can choose to allow the ladder to mature. This perspective allows an investor to maintain a long-term view and worry less about short-term price movements.

Exhibit B  Ladders may result in positive income and total return even in rapidly rising rate environments.

<table>
<thead>
<tr>
<th>Starting investment</th>
<th>Minimum credit rating</th>
<th>Maturity start and end year</th>
<th>National or state portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000,000</td>
<td>AA Rating</td>
<td>Year 5 to Year 15</td>
<td>National</td>
</tr>
<tr>
<td>Duration to maturity</td>
<td>8.4 years</td>
<td>Tax-free yield</td>
<td>Taxable-equivalent yield</td>
</tr>
<tr>
<td>Maturity</td>
<td>10 years</td>
<td>2.36%</td>
<td>4.18%</td>
</tr>
<tr>
<td>Tax summary⁠³</td>
<td>Federal rate tax</td>
<td>State tax rate</td>
<td>Health care tax</td>
</tr>
<tr>
<td>39.60%</td>
<td>0.00%</td>
<td>3.80%</td>
<td>Effective tax rate</td>
</tr>
<tr>
<td>Cumulative Data</td>
<td>5-year cumulative income</td>
<td>5-year cumulative total return</td>
<td>5-year cumulative tax-equivalent total return</td>
</tr>
<tr>
<td>$131,866</td>
<td>15.79%</td>
<td>27.61%</td>
<td></td>
</tr>
</tbody>
</table>

Estimated Annual Income

Source: Eaton Vance. The information and illustration presented in the scenario tool is for hypothetical and illustrative purposes only. Results may not represent the experience of individual investors, and should not be construed as tax or legal advice. An investor should consult a financial and/or tax professional concerning his or her specific situation before making any financial decisions. Any references to future returns should not be construed as an estimate of the results a client portfolio may achieve.

Yields, cumulative income and total return shown do not reflect the effect of fees imposed by an investment manager nor does it reflect the impact of taxes. Fees and taxes will reduce the value of a client’s portfolio. Past performance is no guarantee of future results.

The chart presented does not represent the results that any particular investor actually attained nor the results of any Eaton Vance product. The information presented is based, in part, on hypothetical assumptions. No representation or warranty is made as to the reasonableness of the assumptions made or that all the assumptions used in achieving the returns have been stated or fully considered. Simulated results have many inherent limitations and no representation is made that any account will or is likely to profit similar to those shown in the scenarios. Actual performance results may differ, and may differ substantially, from the simulations. Changes in the assumptions may have a material impact on the hypothetical results presented.

¹Assumes investor is in 39.6% federal tax bracket, highest state income tax rate, subject to the 3.8% medical care tax and that state tax is deductible from federal income tax. ²Income is grossed up at [1 minus the effective tax rate] and all interest income is exempt from federal tax. If state portfolios are selected, all interest income is exempt from state and federal tax.
Professional credit oversight: avoid potential landmines

After the 2008 financial crisis, navigating the muni market has become a greater challenge for individual investors. The elimination of the AAA insurer guarantees reinforces the need for continuous credit analysis of the underlying issuers. And while balance sheets of muni issuers are generally improving, the threat of unfunded pension liabilities and strained budgets still looms large. Downgrades alone may destroy years of performance.

Risk exposures should align with an investor’s unique set of circumstances, so careful analysis is needed to avoid landmines like Detroit and Puerto Rico. Professional credit research is designed not only to uncover potential value, but also provide ongoing monitoring of an issuers’ credit profiles. Rigorous credit review and monitoring is a key benefit of professionally managed laddered portfolios, potentially eliminating or reducing a major source of unnecessary risk for both investors and financial advisors.

The power of institutional pricing and execution

Market access is another potential benefit for investors who choose professional management for their laddered muni portfolio. Obtaining the best execution price is a difficult undertaking for individual investors. The number of dealers in the municipal bond market has shrunk because of industry consolidation, and the remaining dealers carry comparatively smaller inventories of muni bonds.

Individual investors who are able to find counterparties may pay a hefty price to execute trades. A study released by the U.S. Government Accountability Office (USGAO) in January 2012 found that, relative to institutional investors, individual investors typically pay higher prices when buying muni bonds and receive lower prices when selling these securities. One of the main reasons is because spreads are highly dependent on the size of the trade; individual investors and financial advisors who trade smaller blocks of municipal bonds are paying more to do so, as Exhibit C shows.
Individual investors may realize more favorable spreads on their muni securities transactions by enlisting the help of an investment manager who may receive better pricing and execution through aggregation of trades, leveraging relationships with a variety of local and national broker-dealers.

The Eaton Vance approach to laddered muni portfolios

Eaton Vance has been a leader in tax-exempt investing since 1979, and our portfolio managers have over a century of collective experience with municipal bonds. In addition, our credit research team draws on decades of municipal market experience to apply our credit research process.

Our laddered muni approach available for separately managed accounts allows for complete portfolio customization, including options for taxability, credit quality and maturity ranges, as well as the ability to select national or state-specific exposure.

We offer a complete transition analysis that includes details on:

■ Current portfolio statistics, maturity structure and credit breakdown.
■ A listing of bonds we would elect to keep and which we would sell.
■ A sample portfolio report with corresponding maturity and credit breakdown.

In transitioning, investors can retain bonds that fit size, credit quality and maturity. Bonds that do not fit can be opportunistically sold with institutional selling power. These bonds are offered for as long as 60 days to over 100 dealers as we seek to sell near the pricing evaluation.
Disclosure

Credit ratings measure the quality of a bond based on the issuer’s creditworthiness, with ratings ranging from AAA, being the highest, to D, being the lowest based on S&P’s measures. Ratings of BBB or higher by Standard and Poor’s or Fitch (Baa or higher by Moody’s) are considered to be investment-grade quality. Credit ratings are based largely on the ratings agency’s analysis at the time of rating. The rating assigned to any particular security is not necessarily a reflection of the issuer’s current financial condition and does not necessarily reflect its assessment of the volatility of a security’s market value or of the liquidity of an investment in the security.

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About Risk

An imbalance in supply and demand in the municipal market may result in valuation uncertainties and greater volatility, less liquidity, widening credit spreads and a lack of price transparency in the market. There generally is limited public information about municipal issuers. As interest rates rise, the value of certain income investments is likely to decline. Longer-term bonds typically are more sensitive to interest-rate changes than shorter-term bonds. Investments in income securities may be affected by changes in the creditworthiness of the issuer and are subject to the risk of nonpayment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments. A portion of municipal bond income may be subject to alternative minimum tax. Income may be subject to state and local tax.
About Eaton Vance

Eaton Vance Corp. is one of the oldest investment management firms in the United States, with a history dating to 1924. Eaton Vance and its affiliates offer individuals and institutions a broad array of investment strategies and wealth management solutions. The Company’s long record of exemplary service, timely innovation and attractive returns through a variety of market conditions has made Eaton Vance the investment manager of choice for many of today’s most discerning investors. For more information, visit eatonvance.com.
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Strategies. For times like these.

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