

Falling Dominoes: Distraction or Opportunity?

March 2nd, 2011

Historically, at RSW, we tend to communicate more frequently during periods of high anxiety. Today, we are pleased to communicate not about an imbalance of sellers to buyers, but instead, about too few securities available in the marketplace to meet the increased level of demand. As you may recall, we stated previously that the new issue supply glut in the fourth quarter of 2010 was created by issuers shifting some of their 2011 borrowing needs from the first quarter of 2011. To wit, January and February 2011 issuance volume is at the lowest levels seen since 2000.

There were a number of elements that contributed to the municipal bond market’s late 2010 drubbing. The two most prominent “cornerstones” were increased expectations of widespread municipal defaults (widely exaggerated and condemned), and the expected expiration of the Build America Bond Program (BABs). As issuers rushed to the market in advance of the December 31, 2010 BABs issuance deadline, the next domino fell – light investor demand relative to the glut of supply. This caused a cascading effect that resulted in dramatically higher tax-exempt yields, and correspondingly lower prices. Many of the other forces impacting the late-year market are shown below:

Short Term Market Anomaly





During trying times some market participants second-guess themselves, and question whether or not their “long-term” investment policies are sound, or appropriate. It is precisely at these times that the benefits of maintaining a disciplined and methodical long-term approach can seem the most difficult concept to adhere to -- but can reap the most rewards. Notwithstanding the recent market volatility, the municipal bond market has delivered relatively strong and consistent long-term results. According to Barclays Capital (as quoted in their January 7, 2011 Municipal Research Publication), “Over the last ten years, on a taxable-equivalent basis, municipals have outperformed all major fixed income asset categories, and equities, and maintained lower volatility than many of their taxable counterparts (Treasuries and High Yield Corporate Bonds)”.

Investing versus Trading

Although it has taken longer than we anticipated, the tax-free market in general is returning to normal, and, in particular, as it applies to RSW’s investment structure, callable bonds are once again being valued at a “premium”. This rebound has been significant as the tax-exempt market is up 1.59% for the month of February (total rate of return as measured by the Barclays Capital Municipal Bond Index).

Looking back over the past twenty-five years, I can’t recall a time when selling what’s “cheap” in exchange for purchasing what’s “expensive” has ever worked in an investment sense (as opposed to a trading sense). We hope that we don’t appear too cavalier when we refuse to join in the panic and sell the “cheap” sector, to buy what’s expensive -- such as selling 15 year bonds in exchange for shorter maturity debt. In contrast, during the most recent market tumult, we engaged in the opposite tactic. Where appropriate, we sought the opportunity to extend the average maturity, call structure, and or duration of RSW’s client accounts in order to capitalize on the long-term relative value offered in these sectors during the recent market upheaval. Volatility often causes price dislocations and discrepancies that afford active managers an opportunity to enhance portfolio returns over time.

All of this seems quite basic, but it is easy to understand how individuals can become apprehensive during challenging periods in any asset class. Tumultuous times can also be viewed as instructional however, as individuals reflect on whether they are more focused on short-term price movements of tax-exempt bonds (“trading mentality”), or a philosophy that is rooted in long-term “investing”. With that said, the time to question any investment strategy should not be during a “two standard deviation move”, or during periods of extreme calm. Instead, the overall effectiveness of a strategy should be evaluated only after a full market cycle, which encompasses periods of dramatically rising and declining prices. In other words, what did you lose sticking



with your philosophy during the bad times, and what did you gain during the good times? When things are bad, it's easy to call for the end of the world, and when prices are increasing it's so easy to see nirvana.

Our job, at RSW, is to have the ability to function during an "earthquake". We employ a methodical investment philosophy in which we utilize pre-determined buy and sale disciplines to work through the firestorm. In no way does this imply that the "ride" will always be smooth or comfortable, or that any strategy can't underperform over short periods of time. Over the long haul, our successes come from believing in what we do, keeping our wits about us, and acting in a calculated and analytical fashion.

Falling Dominoes can create a panic, causing some to engender a bunker mentality, while others choose to employ an unwavering and consistent investment approach.

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