Inside the portfolios

Delaware National High-Yield Municipal Bond Fund
Delaware Tax-Free USA Fund
Delaware Tax-Free USA Intermediate Fund

Municipal bonds, with their tax-exempt status, offer an important opportunity for many investors. However, the portfolio management team – its style, its experience, and its mindset – can make a difference in municipal fixed income choices.

Key fund features

- Income-driven, risk-controlled approach
- Disciplined, bottom-up research-driven process
- Experienced management team dedicated solely to municipal bond investing

Greg Gizzi
Senior Portfolio Manager, Municipal Fixed Income

Senior Portfolio Manager Greg Gizzi, one of three on the 13-member dedicated municipal bond team, discusses the group’s distinctive, team-oriented approach.
Why is the income component of total return so essential to your philosophy and way of approaching the markets?

We believe that income is the most important component of total return over the long term. It’s a belief that informs our daily thinking, right down to the basics of our portfolio construction process. We think it makes sense to keep overall portfolio duration neutral (similar to duration to the benchmark index), focusing instead on selecting issues that meet both our income and stringent credit requirements. Our emphasis on income is also driven by the benefits it can hold for our clients during market disruptions; the income stream can cushion the negative effects of rising rates, falling bond prices, and periods of general market weakness.

The team talks about being “right sized.” What tangible benefits might that potentially bring clients and shareholders?

The term “right sized” means being large enough to have good access and being significant to the dealer community, while being small enough to effectively execute our investment process. The current size of our funds still allows us to obtain meaningful allocations on new issues, which have become increasingly more competitive. We also have the ability to react to the daily market realities of a dynamic market. At times when liquidity becomes an issue in the market, we often find that we have dexterity. We have the capability to make changes to our portfolios without disrupting the market. We believe the flexibility and adaptability provided by our “right size” has the potential to enhance returns for our shareholders over time.

What are the risk management processes day-to-day within the strategy?

Our approach to managing risk has several facets, beginning with our initial screening of potential investments and running all the way through our daily surveillance of existing holdings. At the portfolio level, we apply performance metrics that give us a good picture of our portfolio characteristics versus our peers and benchmarks. Compliance checks are another part of the picture, occurring from the individual trade level to the portfolio level (including client-specific guidelines). All along, our team of research analysts makes sure our initial assumptions about each bond continue to hold up over time.
Has the market for municipal debt fundamentally changed in recent years, and if so, how?

Change has occurred, without question. We think it’s fair to say that the global financial crisis was an inflection point for municipal markets. In fact, it was quite likely the most transformative event in the history of municipal markets. First, the collapse of monoline insurance recast municipal markets as a credit market instead of purely a rates market.

Second, there was a significant reduction in the number of bond dealers through attrition and mergers, which, along with increased regulation, has translated to lower liquidity. On a positive note, offsetting diminished dealer liquidity was the education of a significant number of nontraditional, total-return investors through the creation of the Build America Bond market. The current municipal investor base has arguably never been as deep as it is today. All of these represent fundamental changes from 10 to 15 years ago.

When might a national municipal strategy appear advantageous to an investor, as opposed to a state-specific strategy?

Single-state investing certainly has its place, especially when you consider how notable the math can be in states that impose high tax rates. Residents of California and New York, for instance, can probably build a strong case for investing in municipal bonds issued in their home states. Those states typically issue significant debt and are issuers in all sectors of the municipal market. Investors are able to get ample diversification within those states. But a national strategy starts to make sense when you think about things like event risk. As risk-aware investors, we believe in asking, is it beneficial to accommodate event risk by diversifying among multiple states? We think the answer is yes, and an allocation to a national municipal strategy is a good way to do it.

How should individual investors view the handful of high-profile credit issues within muni markets in recent years?

Thankfully, investors have compartmentalized the events that have unfolded in places like Puerto Rico and Illinois. There seems to be a level of genuine understanding about the problems at hand, and investors have voted by effectively widening credit spreads, or discerning between high-and low-quality issues. A look at total return for the Bloomberg Barclays High-Yield Municipal Bond Index in 2015 exemplifies this: The Index posted an advance of 1.81%, while returns excluding Puerto Rico were substantially higher at 7.53%.

What are some of the misperceptions investors may have about default risk, or credit in general, in the municipal marketplace?

Investors might overlook the fact that municipal default rates are extremely low, and certainly very low when compared to corporate debt historically. Investors might also be unaware that municipal defaults tend to be confined to lower rated or nonrated project finance deals, versus the more traditional general obligation or revenue bond corner of the market. Investors might also not know about some of the technicalities and hurdles that stand in the way of a municipal default, such as the fact that some states do not even allow municipal debt issuers to file for bankruptcy. In many states these hurdles make filing for bankruptcy a challenging proposition.

What major factors do you expect will influence bond supply in coming quarters, and how does the team approach supply-demand dynamics generally?

While we can’t predict precisely what’s coming down the supply pipeline, we generally think refunding volume will be down by approximately 10-15%, given the elimination of tax-exempt advance refundings under the final tax reform legislation. Refundings are currently down 68% year over year (as of date written). We also expect to see a continuation of seasonal supply patterns that tend to play out, which have historically resulted in relatively high issuance during certain months (March and June are two examples) and relatively weaker volume in winter and late summer.

As we look out over the longer term: In the United States, we expect that a much-needed overhaul to basic infrastructure will begin to play out, much of which will rely on debt financing.
For more information call us at 800 523 1918 or visit our website at delawarefunds.com

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The Bloomberg Barclays High-Yield Municipal Bond Index measures the total return performance of the long-term, non-investment-grade tax-exempt bond market.

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