

# GenTrust Wealth Management, LLC

## Municipal Securities

While small relative to other fixed income markets, municipal securities are an integral part of most individual investment portfolios, especially among High Net Worth Clients. Valued for their tax-exemption and high credit quality, municipal securities are the third largest holding among US households. Despite being widely held, the municipal market is complex and difficult to navigate.

## Introduction

Municipal securities should be an integral part of most individual investment portfolios, especially those of High Net Worth investors. Valued for their tax-exemption and high credit quality, municipal securities are the third largest holding among US households. Despite its importance to individuals, the municipal market is complex and difficult to navigate for non-institutional investors. Professional Management is essential.

## The Marketplace

There are over \$2.9 trillion in municipal securities outstanding and over 60,000 issuers. Municipal securities can be either taxable or tax-exempt. States, counties, cities or their agencies issue these securities to finance a variety of public-purpose projects including schools, bridges, roads, hospitals, airports, and public housing.

The challenges facing individual investors as they attempt to navigate this marketplace cannot be overstated. Unlike equities with the NYSE, there is no central exchange for buying and selling municipal securities causing prices to be established through direct negotiations between buyers and sellers. In addition, due to lax disclosure rules, the information necessary to value these securities, such as current information regarding a municipality's financial condition, can be difficult to find. The securities themselves are complex. Some contain call or put features and although most securities pay a coupon, many do not. Finally, tax treatment can be particularly complex. If a bond is purchased at a discount, the appreciation could be deemed tax-exempt income, taxable income, or taxable capital gains.

Although the market is diverse and complex, very few market professionals specialize in this space. Of the over 26,000 mutual funds in the US today, nearly 14,000 are dedicated to equities, but only approximately 450 focus on Municipal Securities. Those 450 funds are concentrated across only about 100 managers. The municipal space is thus extremely under researched, and this creates opportunities for those investors who have access to market experts.

With the growing complexity and volatility of the municipal marketplace, expertise is even more important than it was in the past. For years, municipals were viewed as a safe haven. Volatility was low and the municipal marketplace was largely unaffected by many of the events that affected other markets. Market participants were largely buy and hold and saw little need to turnover their portfolios. The market changed rapidly in 2007 as the global credit crises unfolded. Municipal bond insurers failed, and liquidity in the short-term municipal market disappeared. Massive de-leveraging drove prices sharply lower and panic swept the marketplace. Yields skyrocketed. This was an incredible buying opportunity but not many investors were willing or able to exploit it due to the steep losses they had already suffered. Many investors exited the market and have not yet returned.

## 10 Year AAA Municipal Yields



Source: Bloomberg

The market was transformed by the events of 2008 and 2009. Lehman brothers failed and several major dealers were acquired by other firms. Many hedge funds that had specialized in municipal securities closed while the remaining dealers became far more risk averse. With fewer market participants, liquidity diminished and price swings became more exaggerated.

In late 2010, the market saw another steep sell-off as fears of potential defaults fed a new wave of panic. Again, this was an opportunity to purchase municipals, but many individual investors frightened by the headlines liquidated their positions.

On the back of the 2010 panic, the municipal market rallied substantially and was the best performing fixed income market in 2011. However, the market remains volatile and the challenges facing the market this year are formidable. Although improving, many municipalities remain under financial pressure as growth and tax receipts remain slow. Many states and cities need to restructure their pension funds and while this is not an immediate threat, it must be addressed within the next few years. More so than in the past, tax policy is uncertain as municipalities and the federal government seek to raise revenue. These challenges and the inefficient nature of the market create opportunities for those with the expertise and flexibility to exploit them.

## GenTrust's Municipal Security Investing Approach

### Institutional Access

GenTrust brings institutional expertise to our clients. We have long standing relationships with both national and regional broker dealers. These relationships provide us with access to attractive new issue municipal securities as well as access to the information needed to navigate the marketplace. Our position in the marketplace allows us to determine market pricing and bond value. This is crucial when trying to navigate an opaque and rapidly changing market.

As an institutional market participant, we transact at wholesale prices, passing these savings onto our clients. The table below lists several bonds which recently traded in the market. The price difference between where individuals and institutions transact is substantial. <sup>1</sup>

| CUSIP    | Description                                 | Retail Price | Institutional Price | Retail Yield | Institutional Yield |
|----------|---------------------------------------------|--------------|---------------------|--------------|---------------------|
| 091089JC | Birmingham Alabama Water & Sewer, 5s of 43  | 106.51       | 104.07              | 3.20         | 3.86                |
| 442435FD | Houston TX Utility Sys Revenue, 4.75s of 30 | 106.62       | 103.08              | 2.87         | 3.85                |
| 452152KQ | Illinois State (Taxable) 5.75s of 37        | 100.00       | 97.56               | 5.75         | 5.94                |

Source: Bloomberg

Of course, mutual funds also provide institutional access, but at a cost. Their size prevents them from being selective or flexible. Nearly 75% of the mutual fund municipal bond market share is controlled by the top 7 players (Alliance Bernstein, American, Fidelity, Franklin Templeton, Nuveen, Oppenheimer, and Vanguard). With such large sums of money to deploy, they are often forced to purchase large issues or on-the-run securities. We can be more patient, choosing the structures, sectors, and maturities that offer the most value. Below is an actual portfolio purchased by one of our managers purchased in 2008: <sup>2</sup>

| Description                           | Notional | Maturity   |
|---------------------------------------|----------|------------|
| CT State 5s of 21                     | 100,000  | 11/1/2021  |
| CT State 5s of 26                     | 100,000  | 11/1/2026  |
| NYC GO 5s of 16                       | 275,000  | 10/15/2016 |
| NYC Transitional Finance 5.125s of 20 | 200,000  | 7/15/2020  |
| NYC Muni Finance 5.75s of 25          | 275,000  | 6/15/2025  |

Source: GenTrust, Bloomberg

The table below compares the performance of the custom portfolio above with three different intermediate municipal bond funds. The comparison period is from December 31, 2008 through December 31, 2011. <sup>3</sup>

|                                             | Capital Appreciation | Income       | Total Return |
|---------------------------------------------|----------------------|--------------|--------------|
| Custom Portfolio                            | 13.0%                | 15.2%        | 28.2%        |
| Fidelity Intermediate Municipal Income Fund | 6.8%                 | 11.4%        | 18.1%        |
| JP Morgan Intermediate Tax-Free Bond Fund   | 6.3%                 | 10.3%        | 16.6%        |
| Vanguard Intermediate Tax-Exempt Fund       | <u>8.9%</u>          | <u>12.0%</u> | <u>20.9%</u> |
| Fund Average                                | 7.3%                 | 11.2%        | 18.5%        |
| Outperformance                              | <b>6.2%</b>          | <b>3.9%</b>  | <b>10.2%</b> |

Source: GenTrust calculations, MorningStar

## Proactive Management

### Liquidity

We place a high value on liquidity. This minimizes transaction costs and allows us to adjust a client's portfolio easily when necessary. It also allows us to capitalize on relative value opportunities we see in the marketplace. If an attractively priced new issue comes to market which suits a client's portfolio, we can easily and inexpensively reposition the portfolio to incorporate the new issue. Exploiting opportunities such as these will generate more return than simply holding onto slightly cheaper illiquid securities.

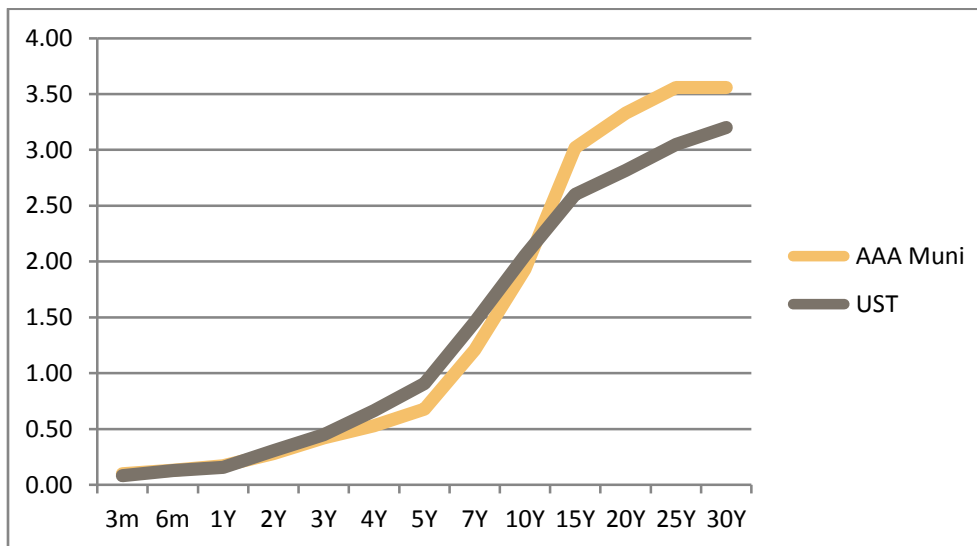
### Issuers

We focus on high grade credits that are undervalued relative to similar credits in the marketplace. The breadth, illiquidity, and lack of centralization foster inefficiency. Similar credits often trade at different spreads and many credits go out of favor due to short term supply issues.

### Term Structure

The municipal yield curve tends to be steep relative to other fixed income yield curves. This is due to the structure of the marketplace. Issuers prefer to sell long term debt to match their capital needs. Buyers on the other hand are risk averse and therefore prefer shorter maturities. With a professional manager overseeing the portfolio, it is not necessary to concentrate on shorter maturities. Our clients benefit as we move farther out on the curve when it is desirable without sacrificing liquidity.

### AAA Municipal Yield Curve versus US Treasury Yield Curve



Source: MorningStar, Bloomberg

### Structure

Municipal bonds take on many forms. We prefer straightforward structures with limited call risk. These trade well and they do not expose the client to significant risk of extension in a rising rate environment.

### **Diversification**

Although some amount of regional diversification may be warranted, municipal high grade credits tend to be highly correlated to each other and so diversification often yields little benefit. Over-diversification hurts portfolio flexibility because it can be very expensive to buy and sell small blocks of municipal securities. As already mentioned, flexibility is essential to capturing market opportunity.

### **Customization**

#### **Investment Context**

We view each client in context. Investment allocations are made in the light of a client's aggregate wealth including the quality of his or her future earnings stream.

#### **Risk Assessment**

We will look at a client's age, their business, and the riskiness of their other investments to determine the appropriate allocation to municipals and the structure of their portfolio.

#### **Tax Efficiency**

The client's tax bracket, domicile, and potential exposure to the alternative minimum tax will help guide investment decisions.

#### **Cash Flow Requirements**

Specific cash flow requirements will be taken into account when constructing the client's portfolio. For example, if a client expects a large capital expenditure in 2 years, we will structure the portfolio around that requirement.

#### **Client Access**

Our investment managers have decades of institutional experience and they are always willing to share their views and thoughts. Due to the inefficiencies inherent in the municipal marketplace it can be difficult for individual investors to obtain the information necessary to make intelligent investment decisions. Headlines can have a significant impact on prices, but the movements they cause are often unwarranted based on the fundamentals. We can filter out the market noise and focus on the information that matters.

## **Logistics and Fee Structure**

### **Fixed Income Management Process**

1. *Initial Assessment* - This begins with a straightforward questionnaire focusing on the overall value municipal securities offer the client. We also analyze the client's current holdings. After these two steps are complete, we conduct an interview so that any outstanding questions can be addressed.
2. *Road Map* - We identify goals and create an implementation plan in light of the points discussed above. The client will review the goals and the plan prior to implementation.
3. *Implementation* - Un-invested balances will be invested in low cost mutual funds or ETFs while we create the appropriate portfolio.
4. *Reviews* - We will conduct regular portfolio reviews and client assessments to ensure that the client's strategy remains appropriate based on our views of the market as well as the client's situation.

## Segregated Accounts

GenTrust uses separately managed accounts so that our clients can easily view their positions and track their account activity. This provides our clients with full transparency.

## Fiduciary Role

As a registered investment advisor, GenTrust has only the client's best interests in mind. Our success is measured by our client's success.

If a client were to choose to use GenTrust as their Fixed Income Manager, the client would sign an investment advisory agreement authorizing GenTrust to execute on the client's behalf. All of the client's investments would be in the client's name. Securities would be held in custody at GenTrust's primary custodian, Fidelity, or an alternative custodian of the client's choosing.

GenTrust debits its management fee directly from client accounts quarterly in advance. The amount of fees a client pays is a regressive schedule which goes down the larger the amount of assets managed:

| Assets Managed               | Annual Rate |
|------------------------------|-------------|
| Up to \$10,000,000           | 0.65%       |
| Everything over \$10,000,000 | 0.35%       |

## Conclusion

Municipal securities, because of their tax-exempt status, high credit quality and income provision, should be a central part of any individual's portfolio. The marketplace, however, is complex and opaque. The complexity, illiquidity and lack of transparency have only increased over the last few years. Individuals are typically left choosing between paying high transaction costs to buy individual securities or buying large, generic and inflexible municipal mutual funds. Many individuals have chosen simply to avoid the sector entirely despite the benefits it could provide an investor's portfolio. GenTrust has the expertise and access to build customized portfolios that meet each individual client's needs while maintaining the flexibility and underwriting discipline necessary to generate significant value.

## Contact Information

For more information or to set-up a Municipal Securities Investment Management account, please contact:

GenTrust Wealth Management, LLC  
 1450 Brickell Ave, Suite 3050  
 Miami, FL 33131  
 Main: (305) 677-6688  
[info@gentrustwm.com](mailto:info@gentrustwm.com)  
[www.gentrustwm.com](http://www.gentrustwm.com)

<sup>1</sup> The bonds listed are for informational purposes only and do not represent actual client holdings or transactions. The information was obtained from the Municipal Securities Rulemaking Board and represents a sample of transactions occurring on December 13, 2011, February 2, 2012, and February 9, 2012.

<sup>2</sup> The portfolio shown (the “Custom Portfolio”) represents an entire portfolio of municipal bonds selected for a single discretionary account managed solely by one of GenTrust’s portfolio managers.

<sup>3</sup> This table is shown to compare the performance of the Custom Portfolio from December 31, 2008 through December 31, 2011 to the performance of several large, well-known municipal bond mutual funds during the same time period. The investment strategy and methods for identifying investments used in the construction of the Custom Portfolio are substantially similar to those used by GenTrust. The results assume that no changes were made to the portfolio and the results do not include the re-investment of income.

Since GenTrust manages its client portfolios according to each client’s specific investment needs and circumstances, we cannot affirm that the returns of the Custom Portfolio are similar to all accounts investing in municipal securities. Therefore, prospective clients should not assume that similar performance results to those shown would have been achieved for their accounts had they been invested in municipal securities during the time period shown.

The performance of the Custom Portfolio is net of a management fee of 0.65% per annum, as well as all other fees and expenses. Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

The volatility of the bond funds shown for comparison may be materially different from that of the Custom Portfolio. The performance results of bond funds do not include the re-investment of distributions.

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