Customized Muni Bond Portfolios

Municipal bonds provide safety of capital and returns that are comparable to investing in U.S. Treasuries, not to mention tax incentives. As the economy struggles and a careful analysis in selecting bonds has been in high demand, municipal bond investing has become more research intensive than ever. Kevin Strauss and Bryan DiDonato at Abner, Herrman & Brock adhere to the firm's criteria for selection by investing only in the highest quality of general obligation and essential service revenue municipal bonds.

Can you give a brief overview of the company?

Abner, Herrman & Brock, which was founded in 1981 by Howard Abner, is an independent investment management firm based in Jersey City, New Jersey. The firm manages customized separately managed portfolios and currently has $850 million under management. We are a 100% employee-owned company.

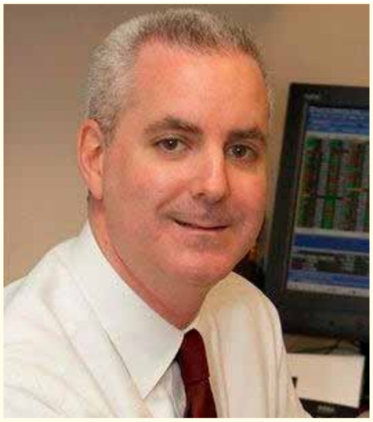
Since the early 1990s we have been more active in managing municipal bond portfolios, and we launched our municipal bond composite in 1993.

What core principles guide your investment philosophy?

We are unique in our investment philosophy in that we customize portfolios to achieve the client's objective. We can manage a state-specific portfolio in any state in the country, national or any combination. We also give our clients direct opportunities to interact with our investment professionals via conference calls or client meetings.

What is more, even though we are more customized and offer more access than others, we also believe in doing this at an attractive fee level so that the client can achieve a strong net total return. We think it is important to keep fees relatively low, so that our clients can still generate enough income from their portfolio given today's lower interest rate environment.

With regard to our philosophy, we believe investors in municipal bonds are typically looking for preservation of principal and a risk-adjusted rate of return. Because of that we manage these portfolios as high quality as possible relative to other investment grade managers.



KEVIN E. STRAUSS, CFA, joined the firm in 2002 as a member of Abner, Herrman & Brock's Investment Policy Committee and serves as President of AHB. Strauss has more than 15 years of experience in managing equity and fixed income portfolios. Prior to joining AHB, Strauss spent eight years with Smith Barney Asset Management first as a research analyst and then as a Senior Portfolio Manager in the firm's Institutional and Private Client Groups. Strauss earned an MBA in Finance and a BS in Business Management from Cornell University. He is a Chartered Financial Analyst (CFA) and has earned the credentials as a Chartered Investment Counselor (CIC).

BRYAN DIDONATO, CFA, joined the firm in 2005 and serves as Vice President at AHB. DiDonato is currently a Fixed Income Portfolio Manager, a member of AHB's Investment Policy Committee and leads AHB's Municipal Credit Research efforts. Prior to joining AHB, DiDonato helped manage a family business. He received a BS in Applied Economics and Management from Cornell University. DiDonato is a CFA charterholder and a member of the New York Society of Security Analysts.

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How do you educate your clients?

We have a diverse client base that come to us either directly or through an intermediary such as a financial advisor. We work closely with our clients and their intermediaries to keep them abreast of current events in the municipal bond market environment.

What is your investment process?

We have a very disciplined process. Every municipal bond that we buy has an underlying credit rating of "A-/A3" or higher. We buy only general obligation or essential service revenue bonds.

We totally avoid another relatively large category of municipal bonds, often referred to as non-essential service revenue. Generally, there are four areas of non-essential service revenue bonds we avoid regardless of the credit quality. Those are municipal bonds in the healthcare sector, housing related, airport, and sports and convention centers.

We are an intermediate maturity manager; however we customize duration to meet any of our clients' needs. We further believe very strongly in diversification. After utilizing our investment screens to narrow down the universe of the municipal bonds, we proceed with identifying individual issues.

On a daily basis, we get inventory screens from dealers that we regularly trade or communicate with. They help with the screening process to provide us with inventory that looks attractive relative to the market while also meeting our minimum quality standards.

Once we locate a bond that is attractive relative to the market, we conduct the credit research on that specific municipality. Some of the key factors that we focus on when we are reviewing financials of a municipality are the operating surplus or deficit that the municipality has, the size of the general fund of each municipality, and any noticeable trends in these areas. We look for any red flags that the rating agencies have not picked up, as we want to avoid possible downgrades to any municipality.

In addition to that phase of the process, we have a number of resources that we utilize. We are subscribers to a number of professional municipal bond research sources that give us additional information and data on many of the areas of the country that we are focusing on.

Our knowledge and experience with those particular municipalities certainly help us and we also tap into sell-side municipal credit analysts as well as bond dealers that we have relationships with. Since they often have traders and analysts all around the country, we often get a bird's-eye view from one of their analysts who is located very close to the municipality we may be considering for purchase.

To sum up, there are a lot of aspects that we take into consideration before we feel comfortable making a purchase of a municipal bond.

What are the various steps in your research process?

Our Investment Policy Committee focuses on the top-down macro issues on a national level. During our meetings we look at different parts of the country that we want to have more exposure to or ones that we want to avoid. Again, we have to marry that with the inventory that is available at the given time in order to focus on what we can actually purchase for our clients.

We have the technology and screening in place to help us monitor the existing holdings by looking at any change in the credit quality, whether it is deteriorating or improving, or has recently been changed by one of the rating agencies. Thus, we continually monitor the credit quality and financial statements of all the municipalities that we own.

Would you use some examples to illustrate your research process?

An example of a bond that we sold is Cameron County in Texas. We became aware of the declining financial condition of Cameron County, which is located in the southernmost part of the state bordering Mexico. An example of the deterioration was that Cameron County had had three consecutive years of negative operating deficit. We took this opportunity to sell the bond ahead of a potential downgrade by the credit rating agencies.

We were concerned that the bond was still "A+" rated and was likely to be downgraded because of the consistent negative operating deficits produced within the county.

An example of a township that we thought was attractive relative to the market and showed some possible improvement trends was Coralville, Iowa, a bond that recently came to the market. Furthermore, the proximity to the University of Iowa provided stability to the town's population base. After reviewing the issuing documents, it appeared to us that the area was on quite an upswing with the population trend, consistently improving for the last five years.

Additionally, farming is an area of the economy that has been improving and we expect it to continue to improve with the rise in commodities prices, so that is a positive factor for Iowa and the population growth in that state. As a whole, it was a bond in an attractive area with a fundamental improvement that was trading at an attractive level.

What percentage of bonds that you own do you hold until maturity?

A high percentage, in fact. We would say somewhere in the region of three-quarters of the bonds that we own are held until they reach maturity. If the fundamentals continue to be strong in those municipalities, we are comfortable holding many of them until the maturity date.

Would you name some of the factors that determine your county selection?

Some of the factors are improving population trends, strengthening financials, and positive demographic trends.

How do you execute your portfolio construction?

Each portfolio consists of at least twenty bonds with no bond weighing more than 5% of the portfolio.

It is important for us to avoid being fully invested in either general obligation or essential service revenue bonds so we seek to maintain a mix or diversification between different types of sectors – water, sewer, school district and general obligations of cities or counties.

For state-specific holdings, we invest in one particular state, but we can still diversify geographically within the state. If it is a national bond portfolio, we will not put more than 15% of the portfolio in one state.

Do you have any pre-payment risk in the bonds that you hold?

Most municipal bonds that we own are callable. There are certain call risks but we manage them very carefully to make sure that if the bond gets called away, we are still comfortable with the yield we would have achieved between the purchase date and the call date.

Do you focus on shorter maturities?

We do not consider bonds that mature any longer than 15 years. Right now, the duration in our portfolios is down into the 4.50 years to 4.75 years from more than 5 years. We also believe in staggering maturities, making sure that we continually have bonds maturing, some as short as one or two years out, some as long as ten or twelve years out.

What are the main benefits of investing in municipal bonds?

First of all, the benefits to high income clients have been vast over the years in that they forego federal taxes on the interest and local taxes if they purchase bonds from the states where they reside. So, relative to investing in bonds of other types of fixed-income instruments which pay interest that will be taxable, there are certainly substantial savings that investors can benefit from.

We monitor very closely the relationship between municipal bond yields and Treasury yields to get a sense of how attractive or unattractive municipal bond yields are at any given time. The average “A” municipal bond has traded at just under par against the Treasury bond over the last fifteen years on average, so the yield is almost the same but the client gets the benefit of not having to pay any federal taxes, and in some cases state and local taxes, on the municipal bonds.

Today, we believe that municipal bond yields are very attractive relative to Treasury yields, as illustrated by the current municipal bond yield being 130% that of the Treasury yield.

What is the size of the municipal bond market and how has it changed over the last ten years?

The municipal credit market is a $2.5 Trillion market. There have been massive changes in the municipal bond market in the past few years and a lot of them have to do with the late 2008 and early 2009 period.

Historically, most municipal bonds carried insurance and the majority of the insurance was AAA. So, most municipal bond investors felt that they owned AAA municipal bonds but what they really owned was a municipal bond that may have had an underlying credit quality of AA, A, BBB, or even B, but were fully insured and were quite comfortable with it.

In late 2008 all of the insurance companies got downgraded below AAA and most were downgraded below investment grade. This has made credit analysis and research of the underlying municipality very critical as the reliability of the insurance has deteriorated.

Consequently, individual clients and financial advisors are learning quickly that they have neither the resources nor the experience and ability to do the credit analysis on these bonds themselves.

The other big change is that during the credit crisis all the wirehouses got stuck owning a lot of municipal bond inventory on their books that was reduced in price. As a result of that, they took losses as they reduced the prices of the bonds in the inventory and significantly reduced the amount of capital that they allocated to municipal bond inventory.

In 2009 and 2010, the Build America Bonds shifted the new issuance from municipalities that were once issuing tax free bonds. That has since gone away at the end of 2010 after the Federal government did not renew the tax exemption. So, this year, all the new issuance is back to the tax exempt world.

Another current dynamic trend is the real lack of new issuance in the municipal bond marketplace.

How many municipal bonds were issued approximately in 2010?

States and municipalities have issued $98.5 billion since Jan. 1 2011, less than half of that sold in the same period last year. Municipal bond issuance has sustained a consistent approximate $400 billion pace a year in both 2010 and 2009.

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Abner Herrman & Brock
asset management

Abner, Herrman & Brock LLC (AHB) is an independent registered investment adviser established in 1981. The firm manages customized separate accounts across a variety of asset classes and strategies for high net worth individuals, foundations and endowments.

Abner, Herrman & Brock claims compliance with the Global Investment Performance Standards (GIPS®)

To receive a complete list and description of Abner, Herrman & Brock's composites and/or a presentation that adheres to the GIPS standards, please contact Kathrine Bendtsen at: +1 (201) 484 2000
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