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How Morgan Stanley's Belsky Steers Around Turbulent Vectors

Michael J. Belsky

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Michael J. Belsky, senior portfolio manager at Morgan Stanley's Vector Group, is looking to steer clients away from turbulence that may be ahead for the municipal market as rates rise.

The three-decade veteran said he avoids timing the market and limits volatility as part of his investment strategy for $120 million of individual municipal bond holdings in Vector's Bespoke Customized Portfolios.

Belsky, who co-founded The Vector Group in 2009, focuses on credit strategies while setting targets for duration and yield curve positioning to earn value for his clients and protect their assets from potentially rising interest rates.

He said a combination of zero-coupon bonds, kicker bonds, and floating rate bonds help him to obtain the best duration and structure as the fixed income portfolio manager in Vector's 14-member team.

The multigenerational team of finance professionals also has two equity portfolio managers who work with clients to manage and transition generational wealth and provides a range of advisory skills and services to Morgan Stanley clients.

Together, the team caters to and manages a total of $1 billion for high net worth clients, small corporations, and endowments.

"We have clients of all ages and risk tolerances," Belsky said this week in an interview.

"The money I manage for clients is to fill a sleeve for allocation," the manager said. "What they are looking for right now is lower volatility. They still want to make money, but want a thoughtful manager than can reduce volatility."

He said his "legacy" clients are older individuals with low risk tolerance and the need for asset allocation.

Prior to joining Morgan Stanley in 2008, Belsky served as associate director with Bear, Stearns & Co. Inc. and senior vice president at PNC Bank, which he joined in 1999.

His strategy includes investing in premium, or kicker, bonds that have higher coupons and five to 10-year calls, including pre-refunded paper for its added safety and security backed by U.S. Treasuries.

It is a strategy that others say can reap rewards in the current market.

"We favor the use of premium bonds given the expectations for rising rates," Jeffrey Lipton, managing director and head of municipal research and strategy at Oppenheimer & Co. Inc., said in an interview on Wednesday.

"Premium Bonds offer the potential for maximum tax-free income and high cash flow and the additional tax-free income compensates for a higher purchase price," he said. "Premium bonds can provide less secondary market price volatility than similar maturity bonds selling near par or at a discount and can offer higher yield to maturity and yield to call than bonds priced at discounts or close to par."

To offset the premiums attached to the kicker bonds, Belsky purchases tax-free zero-coupon securities that offer higher yields than their coupon-payment counterparts.

He is quick to point out that in some cases zeros can offer a 100 basis-point advantage over coupon-paying bonds of the same name and same credit. "I add alpha by pairing the zeros with the premium kicker bonds," said Belsky, who is also a senior portfolio management director.

Lipton said wider spreads on zero coupon bonds have yet to draw buyers, but demand could increase as "the market heaviness abates."

A major institutional investor recently put out a $1 billion bid list, which created an "interesting technical dynamic" in the zero-coupon market, Lipton said.

"Prior to this seller activity, demand was quite strong as zero coupon municipal supply was thin, with spreads on zero coupon munis reaching historically tight levels," Lipton said "Spreads have gotten wider with the market infusion, but not yet to the point where buyers are coming in."

Meanwhile, Belsky balances his clients' portfolios with what he described as one of his core investments – floating-rate bonds, whose coupons trade off of a spread to the London Interbank Offered Rate.

The floating rate bonds offer added protection against higher rates, according to Belsky.

“They may not pay high interest, but it’s part of my secret sauce,” he said. “If you have a vision of higher rates you can anticipate these bonds will be a valuable part of an individual’s portfolio. Right now there are opportunities. Because of the market having discounted higher rates for a long time now, these type of fixed-rate bonds are out of favor, and many times you can find them at good discounts.”

Three-month LIBOR rates have increased to 88 basis points as of Oct. 14, up from 32 basis points a year ago, according to Belsky.

Some of that increase is a direct impact of new money market fund regulations, he said.

The regulations have “ forced money market funds to leave traditional, short-term corporate bond purchases and go to government bonds, so the short-term corporate paper is trading higher in yield and that has had an effect on LIBOR,” he said.

Lipton agreed that there is value in the floating-rate market after new legislation and enforcement.

“Recently enacted money market fund changes and growing prospects for further Fed tightening created a dynamic that offers greater income potential on floating rate securities and possible protection from higher short-term interest rates,” Lipton said.

“The outflows from tax-exempt money market funds ahead of implementation of the new SEC rules have caused municipal variable rate demand obligations (VRDOs) to become quite cheap as they were yielding more than 1-year AAA General Obligation Bonds,” Lipton added.

Belsky’s recipe for a successful strategy also means steering clear of certain investments to avoid volatility.

Currently, he is avoiding general obligation bonds in favor of dedicated revenue-backed bonds, such as transportation and utility bonds, including water and sewer, natural gas, and electric power bonds.

Highway and transit revenue bonds currently account for 19% of his clients’ portfolios, while water and sewer bonds represent 16%, and natural gas and electric power revenue bonds account for 10%.

“The slowdown of tax revenues at the federal and state level and pension and other entitlements are weighing down their flexibility,” Belsky said, explaining why revenue-backed bonds are stronger than tax-backed bonds.

“If it’s a highway bond or transportation bond, if needed, it’s easier for the issuer to raise revenue by toll increases,” he said. Similarly, the recent 23 cent gas tax increase in the state of New Jersey means “more income into that authority so they don’t have to run a deficit,” he said.

While revenue bonds underperformed GOs in September, they are still outperforming GOs year to date, with particular strength in the leasing, hospital, and IDR/PCR, and transportation sectors, Lipton of Oppenheimer wrote in an Oct. 3 report.

Belsky said he is even warming up to hospital revenue bonds "now that more people have health care."

He said continues to buy revenue bonds over GO paper, even though the spread between the two is modest at best.

While there may be some incremental yield available from choosing revenue bonds, that is more of an added bonus, than a driver of demand for Belsky.

"The spread is slight, but that's not the interest to me," he said. "My interest is the down side protection and better credit."

Though they aren't a large part of his investment strategy yet, Belsky said he is taking a harder look at green bonds, which he believes will soon gain in popularity.

"The municipal marketplace is embracing the socially-responsible investment approach in many ways, and I'm just starting to do the research," he said. "But I anticipate these bonds will be a big part of our practice soon."

"The managers that are not looking at this now are going to be left behind," he added.

In addition to minimizing risk, coupon, call date, maturity, and general bond structure are important ingredients of portfolio construction, according to the firm's website. Therefore, the Vector Municipal Bond Portfolios are suitable for investors who are interested in a steady income stream and a low correlation to equities, it states. The portfolios typically are fully invested with high quality bonds from different sectors of the economy and are considered a core fixed income strategy.

To that end, Belsky places a heavy emphasis on security selection. He also maintains an average rating of A in his clients' portfolios, an average duration of five years, and a weighted average coupon of 4.25%.

With variables in the municipal arena, such as interest rate volatility, Belsky's advice for investors is to have a flexible portfolio that is prepared to take advantage of higher rates.

"If you are putting money to work, stay flexible – and liquid," he said, suggesting investors remain on the lower end of duration five years or less and overweight in high quality paper.

His forecast for interest rates calls for the Federal Reserve Board to raise rates in December, then stand pat and monitor the market's reaction going forward.

"I think one is enough and see what happens," he said. Janet "Yellen may not be Fed chief in 2017 and 2018 – so that's something to look at."

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