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Behind the Ratings of Fidelity's Medaled Muni Lineup

Several of Morningstar's favorite muni funds have been shining in 2013's rocky markets.

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Munis have recently been a trouble spot in many portfolios. Markets were first shaken by Fed chairman Ben Bernanke's now-famous "taper" talk and then by a string of bad headlines as Detroit filed for bankruptcy and Puerto Rico struggled to calm investors worried about its deteriorating finances. Against this backdrop, Fidelity's highly rated muni-bond lineup, including Gold-rated Fidelity Municipal Income (FHIGX), Fidelity Tax-Free Bond (FTABX), Fidelity Advisor California Municipal Income (FCTFX), and Fidelity New York Municipal Income (FTFMX), has shown the benefits of the firm's conservative strategy. While these funds have suffered losses, they've fared much better than their respective peers for the year to date.

But Morningstar's Gold rating on these funds goes beyond just their admittedly attractive sturdy performance in the recent sell-off.

An Experienced and Well-Resourced Team

Our respect for Fidelity's muni lineup starts with the strength of its investment staff. Strong collaboration among all of the different team functions—trading, credit research, quantitative research, and portfolio management—sets this group apart. In mid-2010, lead manager Christine Thompson (who had led the firm's muni portfolio managers since 2002) took over as chief investment officer of Fidelity's bond group. But the transition has been smooth. The skilled team she left behind had already contributed to the firm's successful muni funds for several years. Jamie Pagliocco, her comanager on Fidelity Municipal Income since early 2009 and lead manager on Fidelity California Municipal Income since 2006, now heads up the national muni portfolios and muni portfolio management overall. He's supported by comanagers Mark Sommer and Kevin Ramundo, who manage other funds in the lineup. Sommer started running muni funds in 2002, and Ramundo, a longtime credit analyst covering the health-care sector, rounds out the manager trio. All three continue to bring complementary skills to the mix: Pagliocco came from trading, Sommer from quantitative research, and Ramundo from credit research.

Fluid communication links the team. The portfolio managers, traders, and quant analysts all sit at the same desk; they use analytical tools and systems designed to disseminate information across all parts of the team. That includes one of the industry's deepest muni credit analyst groups, which consists of 10 research analysts and seven associates. (The team is currently hiring an additional analyst following several departures during 2013.)

A Careful and Thorough Approach

Across its lineup of national and single-state funds, Fidelity's muni team takes a cautious and careful approach. The team eschews leveraged structures and treads carefully in the market's riskiest names in an attempt to keep its portfolios out of harm's way. In recent years, the credit research has led the fund to local general-obligation bonds with a wide degree of financial flexibility and good transparency and to hospital-revenue bonds; here the team has focused on hospitals it expects to be the beneficiaries of consolidation. In the past, the team has also had success identifying structures that get advance refunded, and this remains an area of focus. When an issuer prerefunds its debt, it backs outstanding bonds with U.S. Treasuries held in escrow and agrees to pay them off at their next call date, giving the bonds' prices a one-time boost.

The fund's managers, traders, and analysts have developed a suite of analytical tools to help them monitor portfolio-level risks through multiple lenses. They habitually hone their process, too. During 2008's worsening credit and liquidity crisis, for instance, the team developed a tool to offer a fund-level view of liquidity risk. As a result, the team now draws on some of the best risk analytics in the business.

Opportunistic, but Generally Conservative Portfolios

Concerned that investors weren't getting paid enough for taking credit or interest-rate risk, Fidelity's muni team brought its funds to 2007 and 2008's turbulent markets with relatively high-quality portfolios and

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limited exposure to the long end of the municipal-bond yield-curve. This positioning helped the funds weather the worst of the period as muni markets were rocked by bond-insurer downgrades, a worsening economy, and forced selling by tender-option bond programs.

In the wake of the credit crisis, the team gradually repositioned its funds to take advantage of better value among long maturity and midquality munis. Those themes largely remain in place, although the team reports recently finding an increasing number of opportunities in the intermediate part of the yield curve.

Through these changes, the team has maintained a high-quality portfolio, focusing on the AA and A bonds, while treading lightly in BBB rated bonds and riskier specific names such as Detroit and Puerto Rico.

Strong Long-Term Record With Good Downside Protection
Fidelity's careful approach can leave its funds lagging their peers in risk-fueled muni markets. As credit-sensitive fare and long-maturity munis led 2009's recovery, for instance, Fidelity Municipal Income trailed the category median by a few percentage points. A similar phenomenon caused the fund to lag the category norm in 2012, a year that was especially kind to credit-sensitive munis as income-hungry investors piled into high-yield muni funds.

The funds' managers avoid the temptation to add yield to their portfolios by going further down in quality or extending further out the maturity curve, though. That discipline has generally helped the fund lose less in downdrafts. That was true during 2008 when Fidelity Municipal Income's 4.6% loss paled in comparison to the double-digit drops suffered by some of its more-aggressive peers; its siblings held up similarly well. Despite suffering losses, the firm's muni funds have generally held up better than their peers so far in 2013 as well: Fidelity Municipal Income's 2.6% year-to-date loss through October is more mild than the loss suffered by close to 90% of its peers. The funds' generally strong performance owes in part to the cushion provided by their stakes in premium callable bonds. Meanwhile, Fidelity's careful approach to credit shows in the portfolios' limited exposure to troubled Detroit and Puerto Rico bonds.

These funds don't rely only on solid defense to drive returns, though. Over longer periods, the team's multifaceted approach has continued a pattern of outstanding total returns with below-average volatility across Fidelity's muni lineup.

Fixed-Income Strength and Progress in Other Areas
As one of the mutual fund industry's giants, Fidelity has pockets of strength and weakness. Its fixed-income operations are among the industry's best. On the equity side, the firm is home to some talented fund managers, who in many cases run Fidelity's biggest funds. However, Fidelity's size hasn't translated into success across the board. Its sprawling lineup leaves room for offerings that have produced mediocre results or endured many manager changes. Fidelity's executive management and fund boards have made consistent performance a priority, but it will take time to gauge improvement.

Fidelity has shown signs that it is willing to evolve. The firm has solidified an experienced-analyst track on the equity side and has kept its sector managers in place for longer. It has also added comanagers for some managers facing capacity constraints. In other ways, the firm is trying to regain its edge. Fidelity has grown its asset-allocation group and revamped its target-date series after losing market share to competitors. A latecomer to exchange-traded funds, Fidelity recently partnered with BlackRock on the passive side and is building out its capabilities for actively managed ETFs.

While Fidelity remains a work in progress in some respects, its fund lineup remains reasonably priced, and manager ownership has significantly improved. Both of these factors have recently boosted its Parent Grade to Positive.

Cheap
Expenses are particularly important for bond funds and even more so now given low market yields. Fidelity's muni funds are typically among the cheapest available to bond investors, and this gives these funds a valuable edge.

Miriam Sjoblom and senior fund analyst Katie Reichart contributed to this article.

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Fund Name	1 YR	3 YR	5 YR	10 YR	Since Inception	Inception Date	Gross** Expense %
	Annual Return % as of 12/31/13						
Fidelity California Municipal Income Fund (FCTFX)	-1.73	5.83	6.43	4.19	6.56	7/7/1984	0.46%
Fidelity Municipal Income Fund (FHIGX)	-2.94	5.04	6.11	4.17	6.43	12/1/1977	0.46%
Fidelity Tax-Free Bond Fund (FTABX)	-2.83	5.24	6.16	4.37	5.06	4/10/2001	0.47%
Fidelity New York Municipal Income Fund (FTFMX)	-2.97	4.24	5.39	3.96	6.78	7/10/1984	0.47%

Before investing, consider the funds' investment objectives, risks, charges, and expenses. Contact Fidelity for a prospectus or, if available, a summary prospectus containing this information. Read it carefully.

* Morningstar analysts assign a Parent grade of positive, neutral, or negative based on the overall priorities that prevail at the firm. Fidelity does not have any involvement in this grading.

** The Gross Expense Ratio is the total annual fund or class operating expenses (before waivers or reimbursements) paid by the fund and stated as a percent
of the fund's total net assets. The values were drawn from their respective prospectuses.

Current performance may be higher or lower than that quoted. Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate, so you may have a gain or loss when shares are sold.

Total returns are historical and include change in share value and reinvestment of dividends and capital gains, if any.

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Fixed income investments entail interest rate risk (as interest rates rise bond prices usually fall), the risk of issuer default, issuer credit risk and inflation risk.

The municipal market can be affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities.

Leverage can increase market exposure and magnify investment risk. Income exempt from federal income tax may be subject to state or local tax.

All or a portion of the fund's income may be subject to the federal alternative minimum tax. Income or fund distributions attributable to capital gains are usually subject to both state and federal income taxes.

Interest rate increases can cause the price of a debt security to decrease.

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