Panelists speak during AICA Summer Summit about Municipal Bond CEF Investing.

Thursday, August 13, 2020

Paul Brennan from Nuveen and Samuel Weitzman from Western Asset Management were panelists at the AICA Summer Summit held on August 13. The moderator of the panel was Patrick Shaddow, of S-Network. Read the transcript from the discussion below to hear the insight from the panelists.

Patrick Shaddow

Paul Brennan

Samuel Weitzman

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Patrick Shaddow: Excellent. I think today since we have such a great panel, what we'd like to hone in on Paul and Sam, is what differentiates your closed-end fund product lineup compared to your peers. What strikes me Paul, is why is Nuveen so muni focused?

Paul Brennan: Well, it's sort of in our DNA. Nuveen started out about 120 years ago in public finance as basically an investment banking firm, and over the decades ultimately evolved into managing assets, muni assets. Started with UITs and we went into open-end funds, and then of course we launched a series of closed-end funds. So we're now part of the TIA organization, so we're now part of a very large trillion dollar organization. But munis, at least historically with Nuveen, it's how we got our start.

It was what the firm was mostly about really until the 90s when we started diversifying into other asset classes, but munis still represents a big part of what we do. I think we have about 77 investment professionals on the muni team, either portfolio managers, research, or analysts, and I think we have about $180 billion under management total in munis. So it's still a big chunk of what we do and we just have a very long history with munis.

Samuel Weitzman: Yeah, and from the Western Asset side, certainly we're a global fixed-income manager with over $500 billion of assets across the globe, munis certainly a small proportion of that but it's certainly a business focus as least. Think of the business opportunities that exist on the closed-end fund side and the broader tax exempt income side, we think the opportunity to invest in tax [inaudible] format is going to be more attractive in the low-yield environment. We think the value of tax exemption gets more interesting and we think the closed-end fund vehicle is a great opportunity to exploit that.

Patrick Shaddow: Excellent. Yeah, so great overview there. The DNA of Nuveen is focused [inaudible], and Sam brings a considerable amount of knowledge to the space from his previous employment as well as his current employment over at Western.

So today, I did want to kind of highlight one thing that I thought was a little funky. As I mentioned before S -Network Global Index currently calculates about 45 closed-end fund benchmark indexes, and only about 12 of them are up and have positive performance this year. Of those 12, seven are muni focused, so why have muni funds performed so well this year compared to the market?

Paul Brennan: Munis have actually done pretty well this year, first and foremost, rates are actually lower for the year. Obviously they spiked quite a bit during the March selloff, but we're actually at rates lower now than before the pandemic. In fact, I think on most measures, at least I was looking into this not to long ago, we're at the lowest yields essentially we've been at since at least the 60s and probably the 50s, so we're in a very low-rate environment. Obviously the Fed is driving a lot of that, the expectations for economic growth are behind that. So rates being down are the biggest factor that's led to higher prices.

And then munis as a class have actually again kind of displayed the resilience, even when we have difficult times like now munis are just a very resilient asset class because of what we're financing with munis. It's municipal infrastructure, it's government, government still has to operate, government still has to provide services. And even when times are difficult those services are provided, they're usually paid for or funded and so there's a lot of examples of munis going through tough times. You can go back 10 years to the financial crisis, munis came out of that okay. The 9/11 terrorist attacks for example, the temper tantrum, I think that was 2013. And then we had a certain pundit get on *60 Minutes* and say there was going to be widespread defaults in munis. Munis again held up under those type of difficult circumstances, so the class itself does pretty well.

Samuel Weitzman: Yeah, certainly I'd just echo your comments, Paul. It's pretty remarkable to think that in March we were sitting at a place where investment grade munis were down 10%

and high-yield munis were down 20%, and now both are in positive territory year-to-date. So we really completed that roundtrip and I think your points are well noted about the combination of lower rates, flight to quality, munis relative to other fixed-income classes are really low-default. The muni default rates since 1970 is 0.09%. If you take the default rate after the Great Recession, that only picked up to 0.16%.

Our view is that even in a bear case scenario or even a draconian scenario where munis default 10 times as frequently as they did after the last recession, you're still well below corporate default rates. And so we think that adds a lot to t he technical picture of strong demand asset class, where you have a lot of high net worth individuals seeking retirement income and wanting to convert riskier assets to more conservative income producing tax-efficient assets. And that's exactly what munis are. We're operating in an environment where a supply of tax exempt muni assets is declining. Muni issuers are issuing more taxable debt and tax-exempt debt outstanding is either being refinanced or maturing and that creates a positive tailwind for the municipal market.

Patrick Shaddow: Yeah, and just to further that point, I think of the 62 closed-end funds that are in the S-Network Municipal Closed-End Fund Index, the underlying holdings in excess of 80% are rated triple B and higher. Those funds roughly payout around 4% per annum in terms of yield, which at a marginal tax rate of 25% gets you roughly 5.3% taxable yield. So yeah, that makes sense to me, but maybe you guys can kind of give a little bit more perspective on the risks associated.

We spoke about default risk, you said it was in the basis points and even if it was 10 times more you'd still be in the 1% of default rate. So I guess my general question here is, if you're a person living on your income generated by your investments, how much focus would you put on duration risk or tax regulation risk or, as we said, default risk? Is there a concern about municipalities being able to repay their loans given the current environment with respect to COVID and the pandemic?

Paul Brennan: I'll start. Clearly post-pandemic and the lockdown of the economy, that has definitely elevated default risk, but I don't even think that's the right way to look at it so far. I think it's really more downgrade risk. As we touched on, the resiliency of munis and state and local government is pretty high and demonstrated, but of course with the lockdown in the economy revenue collection is going to be lower. Traffic, if it's a toll road, it's going to be lower. Landings at an airport are going to lead to lower landing fees. And then obviously there's expense pressure related to COVID expenses. But generally where you're really seeing risk right now is downgrade risk, where because of the lower revenues and possibly higher expenses, that is creating budget gaps and that's going to have to be dealt with and obviously that's going to also put pressure on the balance sheet. So you're generally seeing downgrades by one notch, in some cases two. We haven't seen downgrades yet but it will likely happen because the rating agencies I think correctly are taking a more wait and see approach.

We were getting right into the budget season when the lockdown started. Most states and local municipalities have a June fiscal year end so they were just starting the budget cycle. A lot of that got put on hold as they dealt with the crisis, so a lot of it now is wait and see how do they

respond to plug budget deficits that are both occurring now and likely projected to occur over the next couple of years? And so that will lead to general increased risk, but again it's more like one notch, two notch downgrades.

Now there's going to be some areas where you're going to have more pain being felt by the borrower, but those are going to be more one off situations, idiosyncratic situations, and generally already lower rated or very weak credits prior to the pandemic. So bottom line is that we don't expect widespread defaults but we do expect a significant amount of downgrades that will occur, but not payment interruptions.

Patrick Shaddow: And do you think those downgrades would immediately reflect in the price of the underlying instruments?

Paul Brennan: I think definitely most of that is reflected. There's a lot of bonds that are trading at yields that are higher than what they would normally use for the rating because I think the market is more forward looking in terms of pricing. What you're ultimately seeing too, in a lot of cases for credits that have the same rating, there is a significant difference in pricing because some of these credits are going to get downgraded more than others because they might have more challenges ahead. So I think the market is much more forward-looking. In terms of pricing the rating agencies haven't made wholesale changes yet, I think they're taking wait and see case by case. Which I think is good rather than just doing kneejerk, just downgrade the whole market, I think they're doing it case by case.

Samuel Weitzman: Yeah, our view [inaudible] significant budgetary implications on states and locals as seen as in prior recessions. New York City is facing a $30 billion budget gap, California is looking at a $55 billion budget gap, and that has to be [inaudible] somewhere. But what we have learned from prior recessions is that the majority of the municipal market has tremendous budgetary flexibility to weather those challenges.

I think what's important and probably an undervalued pillar is the degree of support we've seen thus far from the federal government, and likely what is to come. And the ultimate level of direct aid from the federal government will probably inform the degree of austerity measures that will be incurred by states and locals to address those budget gaps. And while austerity measures aren't great for growth, it's what we've seen in the past. So that's really our base case expectation, that they really have the ability to navigate their expenditures to meet their legal obligations such as debt service.

We really do rely on our credit analysts to stress test the risks and opportunities across the muni market, and we think the downstream entities in certain parts of the high-yield market are more vulnerable. Particularly those that may rely on things like retail sales tax collections or part of the high-yield market that had issued under aggressive economic assumptions and weren't baking in a recession let alone a pandemic. And we've seen a few of those deals come in late 2019, particularly in those areas like the CPRC retirement community sector is of concern.

But as Paul noted correctly, we think that's a really small part of the market where you'll see moderate increased default risk, but the majority of the traditional muni market is built to weather the budgetary challenges associated with the current pandemic.

Patrick Shaddow: And do you think that that lends an opportunity to use single state muni closed-end funds as opposed to a diversified muni closed-end fund in and of itself? So in other words, are those specific jurisdictions or states that you would feel more comfortable putting your assets into and your investments into as opposed to a diversified muni closed-end fund?

Samuel Weitzman: I'll start with that. Coming from the product side, I think that we've seen some consolidation of state funds in recent years, and that consolidation is driven by a lack of adequate paper or a lack of adequate diversification. I think most of the high tax states fortunately, where investors can benefit from high in-state investing given the high tax rates, fortunately there is enough issuance to build a diversified portfolio. So not from the closed-end fund side but from a general product side, we seek to offer solutions in most of those states. But certainly given the prospect of higher tax rates at the state level, in-state municipal investment can certainly be effective.

Patrick Shaddow: Absolutely. Paul, anything to add there?

Paul Brennan: I think that's well stated. I think too you answered an interesting angle. I think you're suggesting, is it better to rotate from one state to another? And that's interesting, I guess if you didn't really like New York and you bought-- Ohio was going to better weather the pandemic, maybe you might move money to Ohio. But the other big factors in munis of course is the tax, the tax treatment of munis. Say you don't live in Ohio, you're going to get taxed on that Ohio income. And so I don't see a lot of that happening, but I think the state funds really offer what we see a lot of investors want.

One, they want double tax exemption or triple tax exemption depending on their jurisdiction. They really just don't want to pay taxes at the federal, and state, and local level. And two, many of them like to have their money invested where they live or closer to where they live. We have a Texas fund for example, we had a Texas fund for a long time but there's no income tax in Texas. But Texans they like Texas and so there was a lot of demand for Texas bonds even though there was no tax advantage to Texas residents but they wanted to have their money invested closer to where they live. So the state funds offer that feature as well to investors. But if you're really looking to diversify across the entire muni market, then the national funds are generally the way to go.

Patrick Shaddow: Yeah, it makes sense. In your answer there Paul, you alluded to the tax benefits of investment in muni closed-end funds. Now that leads me to my next question. There's been this ongoing trend of new issuances in taxable muni closed-end funds, now why would someone invest in that? And why are taxable muni closed-end funds some of the best performing funds this year? My index is up over 9%.

Paul Brennan: We're definitely seeing strong demand from international based investors for munis, and obviously they don't benefit from the tax-exempt treatment from tax exempt munis so

they generally would rather have taxable munis because they still yield more. And the yields are pretty high relative to what they can source elsewhere, most sovereign debt is yielding zero, and so munis is becoming more and more attractive.

We've been winning a lot of mandates here to manage taxable money for various institutions, insurers, pension plans, etcetera, and they're very attracted to the high absolute yields. I think in a lot of cases they feel they can also hedge the currency risk, etcetera, and it provides better diversification and good income for their goals. And so we continue to see demand and at the same time there's been tremendous increase in issuance.

The issuance is driven by a few things. Just the absolute level of rates is so low that there's a lot of compression between taxable yields and tax exempt yields, and there's some quirks in the tax reform that was passed a couple years ago that makes tax expect advance refunding not permitted anymore. So a lot of issuers are refinancing their old tax exempt debt with taxable debt and it's still an economic savings for them, so the supply has been there and the demand has been more than adequate to absorb that increased issuance.

Samuel Weitzman: Yeah, I'd echo those comments. When you look at hedging costs from Japan for example, we're seeing the decline in hedging costs of approximately 100 basis points on top of a landscape of increasing negative yielding debt globally. So you're certainly seeing that foreign investor looking for a sovereign-like asset that's high-quality, long duration, and that's exactly what taxable munis are.

And so when you have that longer duration nature of the asset class, you have the rally in rates like we've had, and then you throw on this appetite for high-quality long duration taxable income versus other asset classes. We talked about the relative risk profile of munis versus corporates, munis can offer even incremental spreads for a much lower default rate. It's an attractive value proposition and I think it's driving a lot of the relative value and performance of the taxable asset class.

Patrick Shaddow: It all makes complete sense and definitely answers a question that I've had. One of the other things I wanted to hone in on here is leverage. So majority of the muni focused closed-end funds in the S-Network Municipal Closed-End Fund Index are leverage to the tune of roughly-- 91% of the total weight is in leveraged closed-end funds. What if any benefit is there from leverage, and does that change based upon the current interest rate environment?

Samuel Weitzman: Yeah, closed-end funds are certainly unique in the ability to provide structural leverage, or borrowing against the fund itself, or ability to lever within the fund via individual bond tender option bond leverage. And leverage can be specifically beneficial for munis versus other asset classes because munis yield curve is steeper versus the treasury or corporate yield curve. And that's really a function of the majority of investor preferences in the tax-exempt muni market shifting to the lower duration end, and so you get this relatively steep yield curve. And so what the fund can essentially do is borrow short and lend long, and that can enhance returns.

And then from our perspective we've also seen more closed-end funds try to meet a dividend target. And so we've seen some incremental leverage associated throughout the closed-end fund industry to meet their dividends targets, to hit those higher yields and avoid some of the cuts. At Western we manage levered and unlevered strategies, we think the vehicle of a closed-end fund really fits a certain investment profile for the municipal investor because they're effectively gated from redemptions unlike open-end funds. Where a large degree of performance can be related to the liquidity of the redemptions that they're seeing.

And so in our levered strategies we seek to employ moderate leverage versus tiers, and we think that allows us to forced to unwind leverage or be forced sellers in market drawdowns like we saw in March. And can actually be opportunistic in periods of time, and during those periods of time, extend leverage during drawdowns if valuations warrant.

Patrick Shaddow: Yeah, absolutely. And what happened in March, essentially there was a huge discount of all closed-end funds. The composite of broad-based from commodities to equity closed-end funds, obviously municipals as well as option income of corporate fixed-income. You name it, there was a huge discount in March. Now since March however, there's been more kind of like a reversion to mean.

And what I've kind of been looking at lately is muni closed-end funds in and of themselves over the past few months at least have seemed to kind of trend upward closer back to NAV. Whereas broad-based equity closed-end funds kind of stayed pretty high in terms of their discount. So munis are closing in on the 5% discount rate and equity discounts are closer to 10%. Maybe you guys can talk to why that is. Again, is it just flight to quality? Is it because of the investment grade?

Paul Brennan: I think first it's the underlying performance of the new market, I think investors again were reminded - obviously we had a difficult March - that munis are going to hold up. The resiliency is being demonstrated yet again and the performance has been pretty good so the NAVs have largely recovered depending on the fund and its mandate. And also I think there's more optimism a little bit on the earnings front as we talk about most of these funds are levered and they're borrowing at rates that are tied to short-term rates. And the Fed obviously, with their kitchen sink approach, rates are going to be at zero for obviously for the foreseeable future.

The reference rates for munis, the SIFMA Index at I think 11 basis points, so the funds earnings are benefiting from that because the borrowing costs have come down. And at least in the interim or short-term, the underlying yields of the bonds or the earnings of the bonds that were bought, most of them before the pandemic are obviously still on the books, so that has been beneficial to fund earnings or the sustainability of the dividend for awhile. I think the funds have been rewarded with better valuations. And like you mentioned they're basically back to normal-ish type of premium discount valuations, so I think those are the main factors that are driving improvement.

Samuel Weitzman: Yeah, I would certainly echo that. I think when you think about widening discounts, the two primary things from my viewpoint that really causes discounts to really deteriorate or widen are NAV uncertainty. Which is exactly what we saw in March, where there

was uncertainty whether the NAVs would hold up. And you've seen certain discounts-- I think I saw upwards of 30%, which is pretty unbelievable in the closed-end fund market.

And then the other thing would be earnings sustainability. Usually when you see dividend reductions, and we've seen a lot of dividend reductions across the past decade as rates have grinded lower and bonds have been refinanced in the lower rate environment, that would have caused discounts to widen if there's uncertainty around level payouts going forward. And I think the points Paul hit on where certainly great in terms of that that NAV stability going forward and the earnings potential when you combine one of the backups in yield in March to provide incremental earnings power. And again, the Fed really stomping on the front end of the curve to really provide some value to the leverage costs.

Patrick Shaddow: Yeah, all makes complete sense. So now what I kind of wanted to talk about is some of the benefits of closed-end funds in and of themselves. Over the past few years up until this year and a little bit of last year, there seemed to be a consolidation in the closed-end fund market, there's been more IPOs lately than there have been. But with that said, could you guys talk a little bit about the benefits of buying muni bonds through a closed-end fund structure rather than directly buying them through an open-end fund structure, or the underlying bonds themselves, or as you were talking about, the different types of vehicles you currently manage?

Samuel Weitzman: I think importantly the closed-end fund structure really caters to a relatively illiquid asset class in the muni market. The muni asset class is structurally illiquid when you consider there is over a million securities across 50,000 obligors in over 50 sectors, these securities don't trade maybe even on a yearly basis. So just by virtue of structure of the asset class, munis are relatively illiquid.

But when you take a step further, broker-dealer inventories have declined by over 75% over the past decade as a result of Dodd-Frank. And municipals managed by large fund complexes that demand intraday liquidity or daily liquidity in open-end funds or closed-end funds increased from 400 billion to nearly one trillion. So there's been this widened disconnect of the investors that for parties that provide liquidity on a daily basis against those that might seek it.

And I think this is really important for closed-end funds because during muni market drawdowns typically that aligns with heavy open-end fund redemptions. And those investors in open-end funds oftentimes don't need or want that daily liquidity, but they're paying for that by their neighbor running out the door at market lows. Fortunately for closed-end funds, the structural nature of not having to meet those liquidity related drawdowns is beneficial. I think you can compare an open-end strategy versus a closed-end fund NAV strategy, and you can see that benefit over time of closed-end fund NAV. Now you'll certainly have that individual share price volatility as we saw discounts extend to 30%, but if you're in closed-end funds for a long term and you can benefit from the leverage that it offers, we think that it's a really good structure for a long-term investor in the municipal market.

Paul Brennan: Well stated. One thing I'd add is within in the closed-end fund structure, it's very easy to have the leverage strategy in there and that provides income enhancement as well. It's difficult for the individual investor to get leverage, at least in the tax-exempt space, they really

can't borrow at tax-exempt rates where the funds are designed to be able to do that. So the closed-end structure also allows really effective use of leverage to enhance income as well.

Patrick Shaddow: Excellent, yes. All right, well look, this would be about the time that I open it up for questions. We have about seven minutes left so John, not sure how we open it up to questions but now would be the time if anyone wanted to ask a question to our panelists.

If anyone has any questions, I guess you could click that raise hand and maybe I could allow you guys to speak. No raised hands.

All right, well thank you for all your time today. Again, my name is Patrick Shadow, I work for S-Network Global Indexes and today's panelists were Paul Brennan from Nuveen and Sam Weitzman from Western Asset. We've enjoyed our conversation with you and thank you for the opportunity to walk you through our lives and what we do on a day in and day out basis. So again, you had over 40% of the municipal closed-end fund market represented on this panel and I thank each and every one of you guys. Sam, thank you. Paul, thank you. And John, thank you for the opportunity.

I got one question before we hang up from [inaudible]. On the topic of leverage, can you talk about any deleveraging, if any, that occurred in muni funds in March?

Paul Brennan: None of the funds at Nuveen delevered. We certainly had to talk about that and we did put in some contingency plans. If the market saw off had continued that would have been necessarily because eventually you do trip the max leverage ratios that are permitted. But fortunately, we never had to execute on that plan.

I do know historically there was a few funds that had to delever in the 2008 financial crisis, the deleveraging there did have to occur for a few funds. The other big issue is of course if your leverage reaches, I think it's 50%, maybe Sam has more knowledge on that. A fund has to also suspend dividend payments, which would be really not good as well. So that's a big thing that the funds want to avoid, is having to suspend dividends because that would optically be a really bad outcome.

Samuel Weitzman: No, I completely agree with that and certainly aware of those 40 Act requirements as well. I think that's why you have to monitor the leverage on an ongoing basis, and we certainly have to meet several tests and have to get our floating rate notes rate notes rated and associated with the leverage ratios as well.

The one thing I would just add is that the leverage is really tied to that SIFMA rate. SIFMA went up to 5.2% in March and that effectively turns your underlying investment upside-down if you're really investing in a municipal bond at maybe 3-4%, in most cases it's going to be a single A to a double A long-term bond, and so the economics they go away. And as we talk about potentially levering individual securities, I talked to several Wall Street counterparts, it seems like there was a process for many large clients to unwind that leverage in March or delever. But the market came back pretty quickly at the end of March and so that delivering processed effectively never happened. So from my understanding, from an industry-wide point of view, there was

deleveraging going on but ultimately the market came up before that deleveraging could actually happen.

Patrick Shaddow: Yeah, and Paul, that seems to coincide with what you were saying with respect to your contingency plan but not needing to use it. Maybe you could elaborate on the contingency plan that you did have in place?

Paul Brennan: As Sam touched on a little bit, we did a little bit of light selling as a down payment in case the selloff intensified or continued. We never actually did any deleveraging like buy back shares or anything like that, but we wanted to keep our cash on hand in case. Mostly we would delever by using cash to buy back shares or redeem shares, or payback the borrowers if you will. We never actually got to that step but we did have a little bit of down payment, a little light selling across a few funds as a defensive measure in case things were going to get worse.

Ultimately we never had to actually do any deleveraging by redeeming shares or paying back loans, and as Sam mentioned, the market snapped back so quickly. And the other issue he also mentioned is that we were upside-down for a couple weeks, where the borrowing costs spiked, going from 1% to 5% over one of two week period. That wouldn't have been sustainable either because we would have just had negative earnings, and so that was another issue. Really the Federal Reserve's establishment of the money market lending facilities and some of the other alphabet soup facility they put in place was really key to correcting that stress that was going on in the short-term funding market.

Patrick Shaddow: Excellent. Another question we had from the audience. What are your thoughts on the dividend increases lately across the market, closed-end fund space?

Paul Brennan: Well they've mostly been driven by the decline in short-term rates with the Fed targeting zero, that's brought down weekly rates in the muni market down to 10 basis points or so. And all else equal, for most of the funds has led to better earnings and in some cases the funds can increase the dividends. Or in some cases they might be banking those increased earnings to cushion or improve dividend sustainability over a longer term period.

Samuel Weitzman: Yeah, I would just add to that, in addition to lower short-term rates is when you had the backup in yields, if you look at the Investment Grade Index in March, it increased approximately 2.5%. Given that closed-end funds, if you don't have to raise cash to meet redemptions for any reason or to delever, you can invest in that higher yield environment. And so that really provides an opportunity to lock in long-term levels of tax-exempt income which can be passed through to investors. So we're seeing broad scales of dividend increases a few months after that period, that's really what it's related to.

Patrick Shadow: Great. Well you guys answered a lot of the questions I had today in the broad market and specifically municipal closed-end funds. If anyone has anymore questions, now would be the time to ask or we could depart.

All right, well thank you. It was great speaking with everyone today, thank you for the opportunity and hopefully you'll have us all back at the next event. If anyone has any follow-up questions, feel free to reach out to me directly at PShadow@SNetworkInc.com and you can get your questions answered. All right, thanks again Paul. Thanks Sam.

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