RiverNorth's O'Neill: Muni Funds Are 'In The 99th Percentile Of Cheapness'

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Steve O'Neill, portfolio manager at RiverNorth. Read the Q&A below as Steve says the average municipal-bond closed-end fund has a discount of 10.5%, which over the last 25 years would be in 'the 99th percentile of cheapness.' While O'Neill makes the case for buying muni bonds, he says the case for closed-end funds is largely because of the discounts being oversized, noting that the rest of the fixed-income market has not seen discounts get that big. O'Neill notes that if interest rates are peaking, the turning of the trend should help closed-end funds, and particularly muni funds, narrow the discount and generate bigger gains moving forward.

Steve O'Neill

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CHUCK JAFFE: Steve O'Neill, portfolio manager at RiverNorth is here, and we're talking about muni bonds and their start to 2023 now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator is brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry from users and investors to fund sponsors and creators. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're looking in the direction of Steve O'Neill, who co-manages the closed-end fund

trading strategies and oversees the closed-end fund analysts at RiverNorth. You can learn about the firm and its closed-end funds at RiverNorth.com. And to learn more about closed-end funds, interval funds, and business-development companies generally go to AICAlliance.org, the website for the Active Investment Company Alliance. Steve O'Neill, welcome back to The NAVigator.

STEVE O'NEILL: Hello Chuck, it's good to be here. Thanks for having me back.

CHUCK JAFFE: And we had you back after just a few months. I mean, you were with us at the beginning of December as we got into the end of year tax selling, tax-loss harvesting season, and you were finding attractive double-digit discounts at RiverNorth back in December and you were saying it was a good time to be investing in them. Well, the last three months for munis, but the market as a whole, have been an interesting time. I mean, the market got off to a pretty good start and then it fell back to roughly where it was at the beginning of the year, and that's been the roundtrip that muni bonds have made. So if we're basically back to where we were when you and I last spoke, but we've seen interest rates rise and the struggles of dealing with inflation and more in the interim, is this still a good time and place to be investing in munis?

STEVE O'NEILL: Yeah, you laid it out pretty well, Chuck. Yeah, when we spoke in December we liked muni closed-end funds, I mean we still like muni closed-end funds today. You said it right, we've basically gotten nowhere, but it has been a wild ride. January, muni closed-end funds were up six points, in February they were down five points, and this month we're down about 50 basis points, and so call that flat-ish for the year. That being said, the net asset values have marched higher, and so muni closed-end funds on average the NAV is up about two points year to date, and so you've had good NAV performance all things considered but discounts have widened. So you asked if we still liked muni closed-end funds today, the average today is at about 10.5% discount, and looking back over 25 years, that puts us in the 99th percentile of cheapness for munis, and so we continue to like munis based on an asset class view and also the valuations of the closed-end fund space.

CHUCK JAFFE: The 99th percentile of cheapness sounds pretty good, but tax-exempt yields of about 4% in a market where you've got inflation running above that and where the Fed Funds Rate is above that, do I want to take the risk and are they worth it?

STEVE O'NEILL: You're right. Let's just talk about muni closed-end funds in general, we'll talk about that yield and we'll talk about whether that's the right discount or not. Certainly long end of the curve, the yield curve is inverted, you've got long-term rates below short-term rates, long-term rates below inflation as you said, but investors are looking to lock in that income. And when you look at closed-end funds today, investors really need to make a decision; when they allocate to municipals they can buy an open-end mutual fund, an SMA, or closed-end funds. The closed-end fund space is offering about a 4.4% yield today and fund sponsors report their distribution coverage monthly, and last reported it was a little over 100%. But that was kind of the past, we've seen borrowing costs increase here in the month of March and so we should expect distribution coverage to come down, we should expect distributions to come down as well, and so that 4.4% could be closer to 4%. That's the yield that's available in the market. When you look across the different portfolios, most of these are single-A bond portfolios with a 12-year duration, and so again, why buy munis? Investors are looking to allocate to duration, a high quality part of the fixed-income market, and lock in these rates for an extended period of time. You mentioned discounts, we started talking about those as well. When you look at closed-end funds, the first thing that people look at is the distribution yield, which we talked about, but the discounts, those 10% discounts again are very historically attractive for portfolios that are for the most part down the fairway. And so when you look across muni closed-end funds in general, this space is about $50 billion, there's 114 funds in the market today, it is a fairly homogeneous group, but there is a lot of bottom-up opportunities that we find interesting from a potential alpha perspective. But again, the first question you need to answer is, do you want to lock in some part of your portfolio at today's yields? If you do, accessing that income at a discount through closed-end funds is certainly an attractive way to do it.

CHUCK JAFFE: It wasn't that long ago, two years, three years now, where people were talking about the potential for defaults in the muni space. That talk went away almost as quickly as it came up. It was, ew, it was going to be like a crisis, we were worried about it becoming something like what we're seeing now with Silicon Valley Bank, and then nope, just went and disappeared. But as we're in this environment, do you worry at all that muni failures and the rest could come into play because, yeah, we're getting paid to take risk?

STEVE O'NEILL: I think the closed-end fund discounts today don't reflect the requirement that you provide a discount on the asset class. The asset class is what it is, fundamentally it's performing, default rates are historically low and rates are where they are. I mean, we certainly all wish we could get 6-7% tax-exempt yields but you can't. So the market's providing the prevailing interest rate and long bonds across the curve and across different sectors are getting bought and sold, and those are kind of the market rates. The muni closed-end funds, I think do need a discount. So in contrast to the asset class, sometimes the asset class looks shaky and you say, "I'll buy into this if it's a discount." But I think this time is different in that investors are discounting closed-end funds not because they dislike munis or dislike duration, because we've seen investors come back to bonds, we've seen inflows into munis, and so we've seen some stabilization there. The problem, and I think what's fair, is investors are looking at closed-end funds and they're saying, "Yeah, these are interesting. I'll buy some munis. But I'm not so sure about this leverage." And the problem with the leverage is that borrowing costs are higher today and levered closed-end funds pass through the spread between what they earn and what they pay out in interest expense, and currently that spread is low and arguably inadequate. And so someone would say, "Hmm, is the juice worth the squeeze? Should I even care about levered muni closed-end funds?" That's a different question than, "Should I care about muni bonds?" but should I even care about levered muni closed-end funds? And I think that's a fair question when an investor looks at the space and says, "Okay, sure, I want to buy muni bonds. What are my options?" If you can buy an open-end mutual fund yielding 3-3.2% or you can buy a levered muni closed-end fund yielding 3.5-3.75%, which again is below that 4.4% we mentioned earlier, I think many investors say, "It might not be worth the spread. I'm not making enough on the levered closed-end fund to justify the higher beta that I have by owning more bonds via leverage and so I need a discount to get into the trade." The market's telling you today that that discount needs to be 10-15%. Again, the average is 10.5%, but you can really buy large liquid funds at 14-15% discounts, so let's call it 85 cents on the dollar. Investors are saying, "Yeah, I will buy these muni closed-end funds and I'm okay with the fact that leverage costs are high because I think this discount is attractive enough that it provides some asymmetry." Where in various scenarios, we think we could generate some significant capital gains off discount narrowing, and that's a way of compensating me for the fact that this closed-end fund today has

borrowing costs that might not make sense relative to the income they're earning on the assets. And so I would agree that there should be discounts in this space, I don't think discounts should be at the historical average of 3-4% but we would disagree with how wide they are. To go back to your comment, 99th percentile looks pretty good, it certainly does. When we look back 25 years, there's been a lot of periods of acute volatility, and one of those was periods of credit stress for municipal bonds; that's 2020, that was also back in 2008 and the GFC, those were much scarier times and discounts were the same. So I think today's discount reflects the vehicle, the wrapper. It's, "We don't like levered closed-end funds," it's less so about the asset class. I didn't answer your question, which is do I foresee future problems in the asset class? And I can come back to that but I think it's important to say that the discounts today I think are very technical based off the fact that leverage costs are high, and that's pressuring distribution rates, and those distribution rates come down, they look a lot less attractive, these levered closed-end funds versus open-end funds so there's just fewer buyers. They just say, "I'd rather just buy that open-end fund versus XYZ at a 15% discount because the juice isn't worth the squeeze."

CHUCK JAFFE: I would argue that you did answer my question. You talked about how defaults are historically low and you focused on what is more important which is the market. So I want to in the limited time we have left kind of expand just a little bit. Because you just said that investors were discounting closed-end funds generally, and your answer was mostly about muni bond funds, but I think if we took out that qualifier it would have applied to closed-end funds as a tool more broadly. It seems like everything that we're discussing would apply to closed-end funds entirely. Is that the case? And does that mean that maybe if munis aren't the sweet spot, that okay, we still want closed-end funds, we still want the benefit of the big discount, we like the cheapness but we might want to be in other things besides munis?

STEVE O'NEILL: We would say that high-quality fixed income, longer duration assets look attractive in this market environment. The fundamentals for munis look attractive today, the valuations for munis as an asset class at the longer end of the curve look attractive today, and so we like munis for exposure in our duration budget. We would rather have munis than own Treasuries or other high-quality fixed income to get our duration exposure. And so yes, we like that, that is a fundamental call. From a technical perspective, it is true that muni

closed-end funds suffer the most in a flat yield curve because there's not enough meat on the bone on the muni side to offset the high borrowing costs. But again, I think a lot of that's priced in, when you're at 14-15% discounts, the market's just saying, "I've only hated these more 1% of the time." And so I think that presents a very interesting opportunity, and that's discounted much more so than other parts of the closed-end fund space. And so, yes, closed-end funds across the board have this problem, higher borrowing costs lead to lower distributions to shareholders. You pay more, you receive less. Your average fixed-income closed-end fund, your average taxable bond fund, you're nowhere close to the 99th percentile valuations. And so if the overview is, "Yeah, I think borrowing costs are high, I don't want to own leveraged closed-end funds," then if that's the case, then I don't think the rest of the fixed-income market has priced it into the same degree. Now it's important to note that you and I are talking as if the market still believes that short-term rates are going to go, and you look at the forward curve and people are betting on rates coming down, and that's the perfect environment to own levered closed-end funds whether that's levered taxable funds or levered muni funds. If borrowing costs go down and interest rates go down as well, at the longer end of the curve that's a twofer and you do really well on the portfolio level. And then in that environment, sentiment would change dramatically and you could really see discounts narrow, that's kind of the best case scenario for closed-end funds. The rule of thumb for closed-end fund investors historically is sell closed-end funds when short-term rates are rising, buy closed-end funds when short-term rates are declining. And so I would say if the closed-end fund market embraced the broader capital market's view, which is that we've come close to seeing peak short-term rates, then borrowing costs across the board should come down for closed-end funds in the foreseeable future. Again, careful what you wish for, that's betting on a recession. And if you are betting on a recession, then you do want to own these higher quality assets. And so that goes back to, yeah, I think the comment about leverage applies to all closed-end funds, but the recommendation stands, at least in our view, a lot stronger for muni closed-end funds because you are adding that high-quality asset to your portfolio and it has a lot of potential to benefit if and when short-term rates come down.

CHUCK JAFFE: Steve, great stuff, wish we had more time. We'll just have to meet up again later this year as we see how it's all playing out.

STEVE O'NEILL: Thanks a lot, Chuck. I really enjoyed it.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. And yup, I am Chuck Jaffe and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds, interval funds, and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. They're on Facebook and LinkedIn @AICAlliance. Thanks to my guest Steve O'Neill, who manages the closed-end fund trading strategies and oversees the closed-end fund analysts at RiverNorth. Learn about the firm and its funds at RiverNorth.com. The NAVigator podcast is new every Friday, ensure you don't miss an episode by going to where you get the good podcasts and following us there. We'll see you again next week, and in the meantime, happy investing everybody.

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