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AICA CEF Panel: Bank Debt, Tax-Exempt Muni Bonds Offer Yield Option for Income Seekers

With bank debt priced for a crisis and tax-exempt municipal bonds generating unprecedented yields, there's never been a better time for advisors to coax income-seeking retail investors out of money markets and into select closed-end funds (CEF) to help them manage recessionary risk, a leadership panel at AICA's 2023 Fall Roundtable said. This window of opportunity could be short-lived, but it's one that potentially offers attractive yield relative to other fixed income asset classes, experts from Angel Oak, abrdn, and Nuveen said at the November 15, 2023, event in New York City.

The panel discussion, *Tax-Free Investment Grade Exposure: Managing for Recessionary Risk*, also explained how high-yield municipal bonds factor into this rare moment for these CEF asset classes.

Bank Debt

Cheryl Pate, a Senior Portfolio Manager at Angel Oak Capital, opened the discussion with some deadpan humor: "I'm not sure if anyone's aware, but we had some volatility in the banking sector this year."

She said closed-end funds that hold investment-grade bank debt, or subordinated debt, make sense right now because the market for bank debt is "priced for a crisis that never fully occurred."

"What we're seeing is a sector that has gone through quite a lot of scrubbing by a lot of the credit rating agencies," she added, noting there's been "a lot of granularity and disclosure over the three earning cycles that have happened since the regional bank failures in March." Pate said that translates into a certain comfort level with those types of assets at her firm, despite some pricing disparities that factor into structure.

Pate manages Angel Oak's Financial Strategies Income Term Trust, a listed CEF with the NYSE ticker symbol FINS.

Pate said subordinated debt is a growing market because banks typically use it as a capital requirement, rather than for financing, and that banks are highly incentivized to call it at the five-year mark.

"These are typically yield-to-call type products because there is such a high incentive to call and refinance at that point," she said.

Interest rate changes next year could influence the timing of banks' refinancing decisions, but until that happens, Pate sees potentially attractive duration outcomes for income investors. "You're getting paid to wait because they move from their fixed-rate period to their floating-rate period, and in some cases are repricing up 400 to 500 basis points," she said. "So, [there's a] fairly short duration in terms of what you're looking for a call date, but a very nice coupon in the meantime — you're sort of paid to wait — and then you get that pull to par because they're trading in the high 80s to mid-90s today," Pate added.

Looking ahead, Pate said the return of normal-course debt issuance by large, regional banks presages "a good issuance year for 2024" and a promising market overall for bank debt.

Tax-Exempt Municipal Bonds

The panelists were largely positive on tax-exempt municipal bonds as an asset class, with one speaker, Jonathan Mondillo, Head of U.S. Fixed Income at abrdn, laying out three reasons for his generally bullish view of the overall market:

- All-in yield and relative yield compared to both treasuries and corporate bonds.
- Strong municipal market fundamentals.
- Current and future tax policy.

While tax-exempt municipal debt has performed poorly along with other fixed-income asset classes over the last two years, we're now starting to see taxable-equivalent yields north of 7%, he said. For example, Mondillo said, New York City's triple tax-exempt debt is generating closer to 9% taxable equivalent yields.

"So, [we're seeing] long-term, equity-like returns with very low risk, [which] we think presents … one of the best opportunities to invest in tax-exempt munis in probably about 20 years," Mondillo said.

Mondillo is part of a team at abrdn that manages the abrdn National Municipal Income Fund, a listed CEF with the NYSE ticker symbol VFL.

Speaking to his second point, he said municipal fundamentals are "20-plus-years strong" right now, which he suggested dovetailed with recent increases in income, sales, and real estate tax collection. These are "the top three revenue drivers of municipalities," Mondillo said, "and that directly speaks to the fundamental strength of … local governments."

Michael S. Davern, a senior market strategist at Nuveen, echoed that sentiment, saying "tax revenues are still coming, and so there's a lot of strength in the municipal bond market."

"For the most part, we have a strong story going into this recession; massive reserves, way more than we saw in the financial crisis, cities that were scared by Covid and actually did something to improve their liquidity position, and now we're going to go into this recession, hopefully a mild one, with a much better credit profile," he said.

That's a story that can lure retail investors out of money markets, Davern added. "Now is a time to be banging the table with your retail investors to move out of the short end, where you're going to see yields collapse, assuming the Fed eventually starts to cut rates, and they're going to miss the opportunity to grab yield now."

High-Yield Munis

Panelists spoke of tax-free, high-yield municipal bonds as an asset class largely misunderstood by retail investors, but that have potential value in the current economic climate.

"The investor thinks this is a portfolio of risky cities, where really, we should have renamed the asset class tax-free infrastructure or tax-free corporates," Davern said. He said the same alluring story for tax-exempt municipal bands translates over into the high-yield space. High-yield munis, Davern said:

- Have a low default rate.
- Are mostly secured.
- Have a debt service reserve fund.
- Lack refinance risk, avoiding wall-of-debt outcomes on the corporate side.

To hear more valuable insights from this panel, register to access a replay and review the full agenda of AICA's 2023 Fall Roundtable. The cost of the replay is $30 for access to all nine panels.