CEF Track Panel #2: Municipal, Preferreds & Investment Grade Access for an Interest Rate Falling Environment

Wednesday, November 13, 2024

MODERATOR:
Alexander Reiss, Director, CEF Analyst - Stifel Financial

SPEAKERS:
Miguel Laranjeiro, Investment Director - abrdn
Ryan McDonald, Portfolio Manager – BlackRock

ALEXANDER REISS: My name is Alex Reiss, I cover closed-end funds in the research department at Stifel, and our last panel was about mitigating credit risk and our panel is going to handle the opposite side, we are more focused on investment-grade assets, things that have more interest rate risk. We are very lucky today to have two portfolio managers with us, we have Miguel Laranjeiro from abrdn and Ryan McDonald from BlackRock who are here. Both of these guys have very deep experience in munis, so some of the conversation may skew towards that, but the overall theme of investment-grade investing in closed-end funds is what we're tackling. When we first were conceiving this panel, we decided that we were going to discuss this all in the context of a declining rate environment, but given the market reaction to the news over the past week and as of late, maybe talking about it in the context of a changing interest rate environment is more apt. And so with that, I'd just sort of like to dive in and offer a first question to our panelists, and basically just cover it from there. How do you think the landscape has changed with regard to fixed income and the markets overall over the past couple of weeks, and how your thinking has changed? Maybe I'll start with Miguel.

MIGUEL LARANJEIRO: Thanks, Alex. Yeah, obviously there's been a slight selloff in markets broadly across fixed income, also in municipals as the markets pricing in potentially inflationary policy agendas with tariff policy and potentially a growth agenda, we think this presents an opportunity for investment, specifically in municipals. In municipals we've seen supply tick up 40% or so, we think really going into the end of Q4, beginning of Q1 of 2025, we think that serves as an opportunity for a market rally. A lot of the market issuance has taken place in the first three quarters of the year, we think now with investment-grade yields at roughly 5-5.5% tax-equivalent yield, we think now is a good time to get invested particularly in the municipal market at this point, and realize the higher elevated value of the tax exemption of these elevated yields.

ALEXANDER REISS: Yeah, Ryan, did you have anything on that?

RYAN MCDONALD: Yeah, I'm happy to hop in. Just to piggyback off what Miguel said, I think if you rewind back to the end of 2023, you saw a highly volatile rate environment. The volatility has calmed down a little bit, but we think end of 2023, it was really a great opportunity for total return. We saw extremely cheap municipal valuations, technicals were not as the way described them today, they were not tremendously supported from a fund flow perspective, we had repositioned to focus on total return. We think the opposite's true, and very similar to what Miguel pointed it, it's really all about income. When you look at the tax-adjusted yields of munis, whether you're looking at investment-grade munis in the 4% to 450 context, depending on rating classes, or high-yield munis which are 100 to 200 wider depending on the type of credit you're looking at, from a credit spread perspective, it may not look cheap by historical standards, but when you think about the all-in yields and you tax adjust it, high yields offering 8-8.5%, investment grade offering a little less than that, closer to 7%, but it's really, really attractive. I think you do need to be mindful, the prior panel talked about interest rate risk, the uncertainty of where rates could go under this administration and future Fed policy, so I think you really want to be careful of the level of duration risk that you're taking, but from an income perspective we think it looks very, very attractive.

ALEXANDER REISS: Maybe touching on that issue of the high-yield space, how do you think what we've seen over the past week in terms of regulatory issues, maybe with some of the more prominent categories in high yield, hospitals, energy, things like that, has any of that caused a reaction in the market? Do you expect anything from that?

MIGUEL LARANJEIRO: We think within the high-yield space, the potential for deregulation could enhance the credit fundamentals of certain sectors. One that comes to mind would be hospitals, small rural hospitals have been looking for a source of M&A activity, and that's been difficult to come across in this recent administration. We think M&A activity ramps up on the coming administration, which could help some of the smaller hospitals realize economies of scale, bring down their cost pressures, enhance profitability, so we think that's an opportunity for credit strength in the future. Another sector we like is charter schools, we think this administration is constructive on school choice, with that we think some additional federal funding and stimulus behind those programs could enhance school choice, and then that bleed into charter school fundamentals. So those are two sectors in terms of where we think deregulation will help.

RYAN MCDONALD: Yeah, I would agree with those sectors. I think the one other one I'd point out that maybe isn't directly related to legislation from a Trump administration, but if you think we're in the midst of a soft landing or a continuing economic growth, pro-growth policies under the new administration, land development deals, they've been extremely popular with mortgage rates very high and limited resale. You've seen new home buyers in the millennial generation really look at building home once again in some of the hotter markets of California, Colorado, Florida, Texas, Utah, there's been a lot of issuance there. The fundamentals remain very, very strong, it's a good source of yield, and if you think the growth paradigm continues over the next couple of years, I expect that to continue, and that sector in particular to offer a very good source of extra yield pickup.

ALEXANDER REISS: That's interesting. When we were talking about this panel on the phone, we had had a couple of prep calls and I remember, Ryan, you had said some very interesting things about the rise of daily liquidity products such as ETFs and other things, and their impact on the high yield market and on this specific. So maybe going off of some of the high-level stuff and just talking about the little bit of the nitty gritty of managing these funds and how that impacts your day to day.

RYAN MCDONALD: Yeah, so I think at a high level, when you think about the high-yield municipal market, it's fairly liquid 90% of the time, but 10% of the time it can be very illiquid. So I think as a manager of mutual fund products or other products that offer daily liquidity, you have to be incredibly mindful of the liquidity of your portfolio. The gap risk that's involved when you experience bouts of rate volatility, whether you're talking about election, Covid, going back to Meredith Whitney, it can be pretty dramatic, so I think you've got to be careful of the amounts of high yield that you own and how levered that high-yield exposure may be in certain daily liquidity vehicles. Within munis in general, it's no different in high yields, I think it's three quarters of the assets, probably more in high yield are concentrated in daily liquidity vehicles, so it really exacerbates volatility that you see in the rate market, so that's something you need to be mindful of. Obviously income as I mentioned is incredibly important when you're talking about what the end investor wants, but the end investor certainly doesn't want you to be in a liquidity squeeze if we enter into one of these volatile periods. Thats something we continuously monitor in our portfolios.

MIGUEL LARANJEIRO: Yeah, that's a good point, I agree with that. I think the buyer base is predominantly retail, especially in the tax-exempt part of the market. For obvious reasons, realizing the tax exemption, we've seen the corporate tax cut really exacerbate that, where the dominant buyer has been the retail side of the market, but what we have seen is different wrappers help liquidity within the retail side of the market. So where historically the market was composed of mutual funds, now we have mutual funds, we have ETFs, we have SMAs that are a growing influence in the market, that has enhanced liquidity, mostly in the BBB and BB space.

ALEXANDER REISS: With that, can you also just opine a little bit onto any advantages that you see in terms of the closed-end fund structure for helping you guys mitigate that. Whether it's with using leverage, whether it's the control over inflows and outflows, anything to that end?

RYAN MCDONALD: I would say closed-end funds, they don't have to deal with the daily redemptions, so as a portfolio manager of closed-end funds you can obviously weather that storm a little bit better than having to be fully invested in a mutual fund or close to fully invested, you can position a little bit for some of those potential outflow cycles. The other product I would reference that I think is strongly increasing in interest and I expect to continue to draw interest is the interval funds. Interval funds with quarterly lockups with some fixed redemption schedule, I think within the high-yield municipal market and to a certain extent in the IG municipal market, provides you with a greater ability to take advantage of those outflow cycles and you can really generate meaningful alpha if you're the one that's able to provide liquidity, which you can do in a closed-end fund. I just think it's a little bit easier within an interval fund, that's I think one trend we are likely to see increase in the coming years.

MIGUEL LARANJEIRO: Yeah, I was going to follow on Mike's thought with respect to the closed-end funds being a provider of liquidity when there are bouts of illiquidity, could enhance total return. That's one of the advantages that a closed-end fund vehicle has, not dealing with constant inflows and outflows. If you're a provider of liquidity, you can lock in attractive yields for a long duration of time where mutual funds might not have that availability in an outflow cycle.

ALEXANDER REISS: Interesting. So I'd like to circle back to some of the higher level stuff that again when we were doing prep for this call we talked about the two rates that are always critical, right? Tax rates and interest rates. We touched a little bit on the interest rate story, maybe we'll come back to that in a bit, but just some thoughts on the changing landscape for tax rates, anything that you guys are seeing early? Thoughts on the state and local tax exemption? Where things are shifting around and maybe how investors are preparing or how a portfolio manager is thinking about those issues this early.

MIGUEL LARANJEIRO: Yeah, we think there's a lot of uncertainty in regards to the tax policy. It seems with the possibility of a republican sweep, the TCGA will extend their tax cuts, so that should be business as usual really from a market perspective. I think the risk to the municipal market is the potential cut, additional cut to the corporate tax rate down to 15%, that could impact the buyer base potentially. So where I stated earlier that our buyer base is dominant predominantly composed of retail investors, I think that's going to have to continue especially in light of a potential 15% corporate tax cut.

RYAN MCDONALD: Yeah, 100%. I think the market is increasingly now a retail-driven market just given the disparity in tax rates that could be exacerbated in this administration. There's the potential for some changes to [SALT 0:12:14] which could I think from a credit perspective help some of the blue states and incrementally help with demand. Yeah, I think I'd leave it there.

ALEXANDER REISS: Great. Okay, so now to some of the more parochial interests that we deal with, I know that I deal with when I deal with retail clients all the time in closed-end funds, there's always this tension between yield-oriented strategies, between total-return strategies, I remember again in our early conversations, Ryan, you had mentioned some interesting things about convexity in the bond market and some of the tradeoffs that managers have to do and what some of those implications are. I was just wondering if you could share some of that.

RYAN MCDONALD: Yeah, happy to go into it. So I think the municipal market for forever has been called a 30-year non-call 10 market, but you have a buyer base that focuses on income, and maybe doesn't focus as much on the call option that's embedded in munis as say the mortgage market does. So I think for years you saw some inefficiencies in the market with respect to placing a higher value on income over the convexity characteristics of municipal bonds. And when we saw the flood of low-coupon bonds come into the market before interest rates rose, and then you had the subsequent interest rate selloff, and this was never more of an event in the closed-end fund market where you had low book yields and you had a flattening and even inverting yield curve which created an imbalance in the funding market for closed-end funds. Various closed-end funds, including ourselves and I'm sure others, felt like clients were focused on income, so selling some of those lower coupon bonds to generate more income to more balance out the income of your portfolio versus how you were funding it was what I think a lot of fund managers were focused on. At the end of 2023 when the market rallied a ton, you obviously sacrificed a great amount of total return by selling down your low dollar price, low coupon bonds, that had you held onto them would have generated substantially better performance. I think that's the tradeoff that you always have to keep in mind, where do you think the trajectory of rates are? Where's the dollar price of your portfolio? What is the downside versus upside duration risks that you're taking and associated convexity risk in your portfolio? I think within the municipal market, that has become a much greater focus since rates have increased than it was in the lower interest rate era, I'd expect that to continue. The paying up for a higher coupon bonds versus not paying up for a lower coupon bond and a lower dollar price bond isn't as distorted as it may have been four or five years ago.

MIGUEL LARANJEIRO: Yeah, I think that's an evolving landscape. I think when the municipal market started, they were predominantly a cash flow oriented income generating seeking investor base. I think over time as you've seen interest trickle into the market, that's pivoted to kind of a combination of total return along with coupon clipping investors. So balancing the risks between the two is an evolving process as fund managers, listening to investors feedback and what their needs are in terms of looking for tax-exempt cash flow versus a total return product is something we have constant dialogue on our team about. But I think it's an evolving landscape, the tradeoff between just tax-exempt cash flow, which is what tax-exempt bonds were for, I don't know, the last 30 or 40 years, but that's been changing so I think it's a conversation that needs to be had across the industry.

ALEXANDER REISS: Also it's hard to divorce this issue of income, book yields, interest rates and all of that, from the issue of spreads as well, right? Which is how a lot of closed-end funds make their extra yield, there's this notion of leverage, we've had the Fed already cut 75 basis points. Have you seen any impact from that yet? Can you give people in the audience a notion of how long does it take for the borrowing costs to come down? How long will it take for investors to see that in the [inaudible 0:16:40] of the funds?

MIGUEL LARANJEIRO: So within the muni landscape, borrowing costs are still elevated, we tend to see a lag in borrowing costs, I don't know, three months or so post-Fed cut. That'll start to flow into short-term interest rates. The curve is still inverted in the belly, so leverage costs are still relatively elevated compared to the long side of the curve, but we think over time as the Fed continues down their trajectory, we think the curve will normalize, which should be additive to total return over time assuming high leverage or leverage for closed-end funds. Yeah, I think that covers it on my end.

RYAN MCDONALD: Yeah, I don't have much to add. I think if the Fed continues in the rate cutting cycle, leverage costs will get better. There still is some appeal to leverage for sure, we're seeing closed-end fund dividends still I think at an elevated level relative to what they're able to generate on a tax-exempt yield basis. There's an element of return of capital that is included in those distribution rates that I think most fund complexes are hoping the yield curve normalization ultimately will allow them to grow those yields into where their distribution rates are.

ALEXANDER REISS: That's a wonderful point, an important point. This year we have seen a lot of closed-end funds, a lot of muni closed-end funds preemptively raise their dividends. In normal cycles you would have a scenario, the Fed would start cutting, the leverage cost would fall, the earnings would rise, and then the dividend increases would come. We've kind of put the cart before the horse here a little bit. Can you talk about the impact that you think that those returns of capital have had both on the way that the funds have traded, as well as some of what Ryan was alluding to, the internal portfolio dynamics and the internal earnings of these funds? And will they ever be able to grow to those levels that we see some of these complexes trading?

RYAN MCDONALD: Yeah, that's hard to say, right? It's a function I think of where the Fed takes short rates and what happens to the shape of the curve both in the rate market and the muni market. I think the hope is that rate curve normalization will allow fund families, closed-end funds to grow into those distribution rates. I think part of the reason why you're seeing return of capital and higher distribution rates is obviously the size of the discounts that were embedded in the closed-end fund market, the activism that we've seen I think has contributed to that as well. So we've seen those discounts come down, we'll ultimately have to see what happens with the rate market and the shape of the curve to determine whether or not those dividends have to be cut. My guess is it's some combination of dividends are reduced at certain closed-end funds and higher tax exempt yields from rate curve normalization.

MIGUEL LARANJEIRO: Yeah, in regards to return of capital, we think it does work for short-term rate investors, generally it does tighten in the spread. We think intermediate to long term, these return of capitals really put a crimp on total return and kind of a drag on NAV, so we think long term probably not. It's not something at this point that we have been comfortable with, but in the short term we have seen it close discount rates, but it's an ongoing conversation.

ALEXANDER REISS: Right, and just from my perspective, I think shareholder education and having people understand what their earnings rate versus what their cash flow is, what kind of a withdrawal rate your account can sustain versus why a manager is paying what they're paying is an important discussion to get into. From our perspective we often talk about reinvestment and things like, and that people should sort of get their arms around those issues. Maybe this is a good moment to sort of ask if there's any questions from the audience. I do still have a few here on my agenda, but just sort of survey the crowd.

AUDIENCE QUESTION: Talking about [inaudible 0:20:48] total return versus income dynamic and situations that were presented to you in '22 [inaudible 0:20:56] selloff and then the rally toward Q3 and Q4. How dynamic are the conversations between I guess you, the portfolio manager, and the fund sponsor to allow you to take advantage of these opportunities? So in other words, can you [inaudible 0:21:16] conversations with the fund sponsor, I guess, from making those mistakes?

RYAN MCDONALD: It's a constant conversation. As we saw back in that time frame, hindsight's 20/20, there was uncertainty over how high rates would go, how bad would these funding dynamics get? There was certainly I think, at the time, a reluctance to sell some of these positions because of the thought that there was potential price appreciation coming back in. Just because the technicals at the time were so poor, munis were very cheap, and so there was a broad consensus, volatility and munis are so correlated with rate volatility, when rate volatility came down munis were likely to outperform. It took so long for that to happen, I think a lot of fund managers ultimately were forced to punt some of these lower dollar price bonds and get the income of the portfolio up. But to answer your question, those are constant conversations that were had, difficult decisions were made. I think within the open-end funds, there was certainly if your fund was not levered, a far greater ability to maintain those positions, and within specifically the open-end funds that I manage, I think you saw a significant difference in the performance during that period.

AUDIENCE QUESTION: [inaudible 0:22:50]

RYAN MCDONALD: Yep.

MIGUEL LARANJEIRO: Yeah, I would agree with that. There's constant pressure really in distributions in general, with that we are asked to sacrifice total return. But yeah, first and foremost, there's constant pressure with distributions, so that's a conversation with the sponsor at every board meeting, in between every board meeting, it's a topic that we're constantly circling.

ALEXANDER REISS: Were there any others? Please.

AUDIENCE QUESTION: Yeah, I'm curious. How do you guys [inaudible 0:23:28]

RYAN MCDONALD: I think in the long end you're seeing a lot of demand come back, and so ratios are around, I think 85%, which is below what the five-year average was historically, although five-year average is certainly skewed by how high and dislocated things got in 2020. But there seems to be pretty good support, certainly far more support for the medium part of the curve and the long end of the curve than there was six to 12 months ago. As Miguel mentioned, we saw a pull forward of supply, we saw strong fund flows, the supply was pretty well digested. And if we're entering into a period of relatively muted supply relative to what we've seen year to date, which I think is up 30 or 40%, so we've seen a huge amount of supply, if supply is a little more muted, I think the technicals are setting up quite well. The one caveat is, it's across the market, everyone points to the municipal technical, it's not like BlackRock's any different, it really just comes down to what happens with rates. At the end of the day, what's your rate view, and I'll tell you what munis are going to do. I mean, there's certainly relative value considerations without question that I just mentioned, but rates are the driving factor.

MIGUEL LARANJEIRO: Yeah, I would point to, I mean, when we look at spreads, high yield to munis, high yield looks tight, very tight, historically tight. But when you compare IG spreads to corporate spreads, corporate IG spreads, they look relatively attractive, they look probably, I think they're out in the 70th percentile of where they were last five years. You can clip a 6.75-6.5 tax equivalent yield on investment-grade muni at this point, and the high-yield market as Mike said earlier, you can clip 8 to 8.5% tax equivalent yield. We think that presents a relatively attractive yield given the historically low default rates when you compare to corporates. So yes, spreads look tight relative to themselves, but relative to other asset classes, we think munis look attractive, particularly in the short and then long end, we think we've been putting money to work, kind of a barbell approach, with the curve inverted as it is.

ALEXANDER REISS: I had one to return to you on that issue. Ryan, this is the second time that you've mentioned the rate view is really important, and whatever happens in these interest rate markets is going to have a lot to do with what munis do. Do either of you guys at a firm, is there a house view, how do you manage against the house view? And also as the previous moderate said, the difference between hedging and diversification is the risks you know versus the ones that you don't, how do you balance that process?

RYAN MCDONALD: It's a good question. So definitely there's a house view, we're on weekly calls, we have access to all of our rate strategists across the firm, and so there's definitely a house view. I think every portfolio manager has their own divergence potentially from that view, and you're not obliged to follow the house view as you may be at other places, so we have that aspect of it. I think at the end of the day, one of the most critical aspects of performance is just making sure that you're not taking unnecessary duration risk in your fund. It's very difficult to implement I think an effective hedging strategy, our clients at the end of the day are buying munis most likely for the income, but they understand that they're taking duration risk. You can hedge, and I think if you have strong conviction, and we do hedge in certain of our products with interest rate futures and other tools, but our clients are coming to us to buy municipal bonds, not necessarily undertake a municipal ratio trade that they may not be looking for.

MIGUEL LARANJEIRO: Yeah, we have constant dialogue with our economists. We have chats every day that we discuss ongoing economic indicators, and that informs, their house view informs our outlook on rates, but there is then some dispersion within the management team, within our economist's team, and there's freedom to extend or shorten as the team sees fit. In the end, we're judged really as managers on total return performance, so if we have conviction to shorten up the portfolio or lengthen the portfolio, that's on us, and those results come back in total return and then feedback through the investors.

ALEXANDER REISS: I just want to survey the audience, if there's any questions on rates before we move onto something else? Surveying the room. Okay, great, so I have one more. So I cover closed-end funds as part of the equity research department, I make a joke that I talk about fixed income all day but my boss is the head of equity research. And I have some of my own opinions, but I'd love to gauge your guys' temperature on within the context of the long leveraged closed-end fund, the perpetual fund with long duration, how do you suggest people use this equity stub of an investment company in their otherwise fixed-income portfolio? Do you have advice for positioning or other things that people should have in mind when they're using this tool?

MIGUEL LARANJEIRO: Yeah, so I think closed-end municipal funds provide a diversifier, it's an income generating diversifier in a secured asset class with historically low default rates. Generally, it has a low correlation to equities globally and domestically, so I think for those investors looking to clip coupons and generate cash flow, I think municipal closed-end funds is good fit.

RYAN MCDONALD: Yeah, I would 100% agree. The only thing I would mention again is just be mindful on the duration and manage the duration within the context of your broader portfolio. Yeah, I think munis are a great asset class, closed-end funds are a great way to get incremental return, they are a great diversifier, definitely be mindful of your duration risk.

ALEXANDER REISS: Great. I think that's it that I had for the end of my prepared questions. Does anybody have anything from the audience or do the panelists have anything left? I think we have about two or three minutes left if we need it. Please, in the back.

AUDIENCE QUESTION: [inaudible 0:30:29] what the right timing is for [inaudible 0:30:37]?

RYAN MCDONALD: Sorry, could you repeat the last part of that?

AUDIENCE QUESTION: Can you comment on how long [inaudible 0:30:41]?

RYAN MCDONALD: I can't speak directly to that, but I do know that we've cut some fees on some products. I'm not intimately familiar with how long that'll last, but I'm happy to follow up with you after the panel.

ALEXANDER REISS: Okay. Well, anyway, thank you very much, I think the speakers are going to be available if anybody has anything longer or anything they wanted to go through in private, but thank you very much for the opportunity.

Recorded on November 13th, 2024

Click the link below to go to the home page of Active Investment Company Alliance to learn more:
https://AICalliance.org/

Disclosure: *Views and opinions expressed are for informational and educational purposes only as of the date of production/writing/speaking and may change without notice at any time based on a multitude of* *factors. Speaker's/presenter's/author's opinions are their own and may not necessarily represent the opinions of AICA, its Board, or its staff. Materials may contain "forward-looking" information that is not purely historical in nature, such as projections, forecasts, market return estimates, proposed or expected portfolio composition, and other items. Listed closed-end funds and business development companies trade on exchanges at prices that may be above or below their NAVs. There is no guarantee that an investor will be able to sell shares at a price greater than or equal to the purchase price or that a closed-end fund's discount will narrow. Non-listed closed-end funds and business development companies do not offer investors daily liquidity but rather offer liquidity on a monthly, quarterly or semi-annual basis, often on a small percentage of shares. Closed-end funds often use leverage, which can increase the fund's volatility (i.e., risk). Actual distribution amounts may vary with fund performance and other conditions. Past performance is no guarantee of future results. This material is not intended to be a recommendation or investment advice, does not constitute a solicitation to buy, sell or hold a security or an investment strategy, and is not provided in a fiduciary capacity. Shares of closed-end funds are subject to investment risks, including the possible loss of principal invested. Closed-end funds frequently trade at a discount to their net asset value (NAV).*

STIFEL

Stocks

Analyst:	Reiss, Alexander G.
Reporter:	N/A
Publication:	Active Investment Company Alliance
Publication Type:	Conference
Date:	November 13, 2024
Topic:	Panel #2: CEF Track - Municipal, Preferreds & Investment Grade Access for an Interest Rate Falling Environment
Materials:	
Phone Interview:	no
Comments:	Please forward this disclosure to the coordinator, "Please visit the Research Page at www.stifel.com for the research disclosures applicable to the covered companies discussed." thanks
Non US Analyst Appearing in US	No

Disclosures:

bluematrix®

https://stifelinstitutional.com/capabilities/equity-research/required-disclosures/