Why Some High Yield Municipal Bonds May Be Attractive in Today’s Environment

The market sell-off in March 2020 stemming from the COVID-19 pandemic has resulted in a massive dislocation and may present an attractive opportunity to invest in high yield munis. Since the municipal market dislocation in the fall of 2016, stemming from record issuance and the presidential election, the investor experience had been very forgiving until recently. This was most apparent in high yield munis, where flows had been strong, investor appetite for maximum yield strategies voracious, and high dollar prices of many high yield municipal bonds were not reflecting the extent of their credit risk in our opinion. Before the municipal market turbulence of March 2020, investors asked few questions related to credit underwriting standards and liquidity management as bond prices consistently moved higher. Questions such as: Does the fund have a high concentration of non-rated bonds? Does it employ leverage? Are there ample reserves to navigate illiquidity and capitalize on dislocations?

The market sell-off in March has resulted in a massive dislocation and an attractive opportunity to invest in high yield munis that we’ve not observed in some time. Simultaneously, it is shining a spotlight on those previously unasked questions, and we believe it is time for investors to revisit them.

2019 closed with stellar returns for high yield municipal bond investors, with the Bloomberg Barclays Municipal High Yield Index returning 10.68%. In addition, over the past 10 years, high yield munis have produced the best taxable-equivalent risk-adjusted returns of all major asset classes tracked by Bloomberg Barclays. The March 2020 municipal bond sell-off is presenting investors with what we believe is a compelling opportunity.

FIGURE 1: COMPARISON OF TAXABLE EQUIVALENT RETURNS AND VOLATILITY OF MUNICIPALS AND OTHER ASSET CLASSES AS OF MARCH, 2020

High Yield Municipal Bonds—Broad Range of Sectors and Credit Risk

Not all high yield municipal bonds are created equal, particularly when considering the nature of a project, security features, political considerations, and long-term viability. For example, it is one thing to invest in essential service credits, such as water and sewer authorities, with a well-established consumer base and virtually no competition. It is another to invest in speculative, single site project-finance deals where future tenants or retail consumer traffic is uncertain. While the more speculative segments of the high yield municipal market may reward investors at times, it’s critical to also understand whether this embedded credit risk is well-aligned with the risk profile of the typical municipal bond investor.

NON-RATED SECURITIES AND HIGH YIELD MUNICIPAL FUNDS

Investors often look to credit ratings for a better understanding of the riskiness of a security. While the overwhelming majority of municipal securities are rated BBB or better, approximately 17% of the market is non-rated (source: SIFMA, December 2018). It’s interesting to note that, when considering high yield municipal funds, the average non-rated exposure for the category trends even higher at 24%. (source: Morningstar)
Taking a closer look at this, we evaluated first quarter performance for 2020, relative to non-rated exposure. As indicated in Figure 4, there is a clear and inverse relationship between non-rated exposure and performance. The regression line, or line of best fit, illustrates that **high yield municipal bond funds with less exposure to non-rated securities outperformed those funds that had higher exposure**. While last year the municipal market was forgiving and investors did not need to be as concerned about credit risk, this chart illustrates why these concerns should now be at the forefront.

**FIGURE 4: HIGH YIELD MUNICIPAL FUNDS WITH LESS EXPOSURE TO NON-RATED SECURITIES OUTPERFORMED THOSE WITH HIGHER EXPOSURE | % EXPOSURE TO NON-RATED SECURITIES VS. PEER GROUP TOTAL RETURN RANK FOR 1Q2020**

In January 2020, MacKay Municipal Managers™ published our annual Top 5 Municipal Insights which represent the team’s macro views, as well as themes implemented in the portfolios we manage.

**With regards to high yield municipals, our views both pre- and post-COVID-19 pandemic are**

**Strategic underweight exposures** are likely to drive outperformance in the high yield municipal market. Quality high yield investments will be key as cracks appear.

**Signs of distress are appearing** in certain pockets of the high yield municipal market suggest that poor security selection can lead to underperformance. Therefore, we believe a focus on avoiding losers rather than stretching for winners will be the more successful strategy to investing in high yield municipal bonds. In 2020, prudent high yield municipal investors will likely focus on quality income and avoid leveraged or speculative income.

**Liquidity Management—More Critical than Ever**

In times of municipal market dislocations, particularly one as severe as the March 2020 period, “owning liquidity” within a fund structure is paramount. At MacKay Municipal Managers™, constructing portfolios that include short term securities, rated bonds, and bonds with a diverse buyer base are at the core of every portfolio we manage. Prudent liquidity management can be the difference between reactive forced selling into a liquidity vacuum to meet fund redemptions versus a proactive approach where ample liquidity enables active managers to navigate and uncover opportunities at attractive levels. For example, amidst a sharp municipal market reversal in March 2020 driven by industry mutual fund selling and evolving dealer inventory, MacKay Municipal Managers™ was well-positioned to capitalize on dislocations by investing in bonds at compelling prices.
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Municipal Versus Corporate High Yield Distinctions
While many investors believe the attributes and behaviors of the municipal and corporate high yield markets are the same, there are many significant nuances to consider. It is important to keep in mind the subtle but crucial distinctions between municipal bonds and corporate bonds when discussing high yield.

HISTORICALLY LOWER DEFAULT RATES
From the perspective of creditworthiness, high yield municipal securities have historically produced much lower default rates than comparable corporate bonds while demonstrating higher recovery rates as well.

FIGURE 5: HISTORICALLY, MUNICIPAL BONDS HAVE HAD LOW DEFAULT RATES RELATIVE TO CORPORATES

<table>
<thead>
<tr>
<th>Cumulative Historical Default Rates</th>
<th>S&amp;P</th>
<th>Moody’s</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>MUNICIPAL</td>
<td>CORPORATE</td>
</tr>
<tr>
<td>Aaa/AAA</td>
<td>0.00</td>
<td>0.83</td>
</tr>
<tr>
<td>Aa/AA</td>
<td>0.04</td>
<td>1.03</td>
</tr>
<tr>
<td>A/A</td>
<td>0.09</td>
<td>1.79</td>
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<tr>
<td>Baa/BBB</td>
<td>0.79</td>
<td>4.27</td>
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<tr>
<td>Ba/BB</td>
<td>4.67</td>
<td>14.40</td>
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<tr>
<td>B/B</td>
<td>10.92</td>
<td>26.37</td>
</tr>
<tr>
<td>Caa-C/CCC-C</td>
<td>40.47</td>
<td>56.57</td>
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1. S&P USPF Cumulative Average Default Rates 1986-2018
2. S&P U.S. Corporate Average Cumulative Default Rates 1981-2018

High yield municipal portfolios generally have a higher quality mix as well. As opposed to the corporate market, municipal high yield managers normally invest a sizeable portion of their portfolios in BBB and higher rated municipal bonds. Supply of issues rated BB+ and below within the municipal marketplace is limited. As such, BBB municipal bonds straddle the line between investment grade and high yield and are included in both universes.

The Case for Active Management has Never Been Stronger
We believe prudent investors recognize the need today for professional, active management in the municipal bond market. In the past, many advisors had a high level of comfort buying individual municipal bonds, mostly insured, for their clients. However, those same advisors now recognize that the changes to the municipal market landscape have introduced investment risks and inefficiencies that require the skills of experienced, professional managers. Historical bouts of municipal dislocations, most recently stemming from the COVID-19 pandemic, are important reminders for those investing in municipal bonds that good security selection is imperative.

A HIGHLY FRAGMENTED MARKET AND INDIVIDUAL OWNERSHIP CONTRIBUTES TO INEFFICIENCY
There are 87,000+ issuers and over one million distinct bonds in the $3.9 trillion municipal market (source: SIFMA, Research Quarterly – 4Q19 US Fixed Income Markets). Each year, more than 10,000 new issues are priced and a large number of
those issuers are infrequent participants in the market. Roughly 70% of municipal bonds are held by individual investors, some of whom represent direct holders of the bonds (source: SIFMA, Capital Markets Fact Book 2019). Lacking sufficient investment expertise in a more complex municipal market, behavioral finance and emotion may prevail, as headline news can lead to investors making poor investment decisions.

FIGURE 6: MUNICIPAL BONDS HAVE HISTORICALLY PERFORMED WELL FOLLOWING PERIODS OF STRESS AND SELLOFF

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</thead>
<tbody>
<tr>
<td>INVESTMENT GRADE MUNIS</td>
<td>-5.66</td>
<td>22.43</td>
<td>-4.61</td>
<td>19.58</td>
<td>-6.21</td>
<td>15.45</td>
<td>-4.74</td>
<td>19.81</td>
<td>-3.63</td>
</tr>
<tr>
<td>HIGH YIELD MUNIS</td>
<td>-13.95</td>
<td>30.41</td>
<td>-5.48</td>
<td>31.96</td>
<td>-10.70</td>
<td>19.18</td>
<td>-7.12</td>
<td>34.90</td>
<td>-11.00</td>
</tr>
<tr>
<td>TREASURY’S (5-7 YRS)</td>
<td>1.00</td>
<td>18.46</td>
<td>-3.35</td>
<td>12.97</td>
<td>-4.83</td>
<td>7.11</td>
<td>-3.73</td>
<td>15.43</td>
<td>2.83</td>
</tr>
<tr>
<td>EXCESS RETURN (IG MUNI)</td>
<td>-6.66</td>
<td>3.97</td>
<td>-1.26</td>
<td>6.61</td>
<td>-1.39</td>
<td>8.34</td>
<td>-1.01</td>
<td>4.38</td>
<td>-6.46</td>
</tr>
</tbody>
</table>

Source: Bloomberg Barclays, as of 3/31/20. Post FC refers to Post Financial Crisis. Meredith Whitney is a financial analyst. The column “Meredith Whitney” refers to the period covering her 2010 interview on the CBS program 60 Minutes, in which she said that she expected that 50 to 100 counties, cities, and towns in the U.S. would have “significant” municipal bond defaults within the next 12 months. Post MW refers to the period after Whitney made her remarks. Fed/Detroit refers to the City of Detroit’s bankruptcy filing. Post Fed/Detroit refers to the period after the filing. Market Selloff/Election refers to the period of the market selloff leading up to the Trump Election. Post Market Selloff/Election refers to the period since the Trump Election to the selloff in late February 2020. COVID-19 Selloff refers to the selloff in March 2020 caused by the COVID-19 pandemic-induced market instability.

1. Bloomberg Barclays Municipal Bond Index
2. Bloomberg Barclays Municipal High Yield Index
3. Bloomberg Barclays U.S. Treasury 5-7 Year Index

Past performance is not indicative of future results. An investment can’t be made in an index. Please refer to index disclosures at the end of this document.

FULL TIME CREDIT RESEARCH—ALL DAY AND EVERY DAY

Heightened volatility due to a lack of liquidity, dislocations caused by new headlines, and the reduced new issue penetration rate of municipal bond insurers have made credit research in this space more crucial than ever. It would be highly unusual for most individual investors to have the time, experience, and resources to successfully perform the deep analysis needed on their own. Experienced active managers are well positioned to capitalize on opportunities as well as navigate new risks in today’s municipal bond market.

DEALER INVENTORY AT HISTORIC LOWS

Structural changes in the municipal market have altered the economics of individual investors trading bonds directly. In addition, more regulation, a prolonged low-rate environment, and greater credit risk have reduced the amount of municipal bonds held in brokerage firms’ inventory. As the “Street” inventory of municipal bonds has declined dramatically, municipal volatility has increased due to lack of dealer price support and liquidity has declined. This was never more evident than during the March, 2020 municipal sell off stemming from the COVID 19 pandemic, where broker dealers reduced inventory further as retail investor redemptions hit record levels and dealer hedges went awry as treasuries rallied and municipal prices experienced a steep decline.
Why Duration is a Poor Predictor of High Yield Municipal Returns

Duration is less predictive for portfolios that contain credit risk, particularly non-investment grade municipal bonds. We often say investment grade municipals typically trade “in sympathy” with Treasurys where correlation of price movements, up or down, between the two is usually in line but not completely. As one proceeds down the credit spectrum into lower investment grade and high yield municipals, the relevance of duration and, therefore, rate sensitivity diminishes further. Lower rated bonds are more credit sensitive than interest rate sensitive, and one should also consider the impact of the higher coupon.

Within the high yield municipal market segment, approximately 90% is categorized as revenue bonds where dedicated revenue streams, debt service coverage ratios, and ratings upgrades may experience a boost as the economy strengthens and inflation rises (source: Bloomberg Barclays).

Conclusion

Market dynamics are rapidly changing in all markets. During these times, we believe MacKay Municipal Managers’ underwriting standards give our clients the edge in navigating these unprecedented events. During these times, we remind investors of our five key portfolio characteristics.

1. **Municipals Fund Essential Services** | The municipal market at the heart is funding basic infrastructure including water, sewer, roads, schools, utilities, healthcare, housing, trash removal, and transportation. Our portfolios reflect these basic essential services.

2. **Disciplined Security Selection** | Strict underwriting standards through all markets remains paramount and assist the portfolios through turbulent times.

3. **Focus on Liquidity** | Constructing portfolios that include short term securities, rated bonds, and bonds with diverse buyer universe are at the core of every portfolio we manage.

4. **Commitment to Diversification** | Each portfolio adheres to strict risk parameters in regard to exposure by issuer and sector. The diversification gives the investor a wide variety by geography, by sector, by credit rating, by yield curve positioning, and by enhancement if applicable.

5. **Flexibility/Active** | Market volatility creates either risk or opportunity. The flexibility of our portfolios allows the credit research team, our traders, and our portfolio managers to seek out opportunities during market volatility and dislocations.
ABOUT RISK
All investments are subject to risk and will fluctuate in value. Municipal bond risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. Investing in below investment grade securities may carry a greater risk of nonpayment of interest or principal than higher-rated securities.

INDEX DESCRIPTIONS
Bloomberg Barclays Municipal High Yield Index is an unmanaged index of municipal bonds with the following characteristics: fixed coupon rate, credit rating of Ba1 or lower or non-rated using the middle rating of Moody’s, S&P, and Fitch, outstanding par value of at least $3 million, and issued as part of a transaction of at least $20 million. In addition, the bonds must have a dated-date after December 31, 1990 and must be at least one year from their maturity date.

Credit ratings: Moody’s rates borrowers on a scale from Aaa through C. Aaa through Baa3 represent investment grade, while Ba1 through C represent non-investment grade. Standard & Poor’s rates borrowers on a scale from AAA to D. AAA through BBB represent investment grade, while BB through D represent non-investment grade. Fitch rates borrowers on a scale from AAA to D. AAA to BBB represent investment grade, while BB through D represent non-investment grade.

Bloomberg Barclays Asset Backed Securities Index is a subset of the Barclays U.S. Aggregate Bond Index and tracks asset-backed securities with maturities of at least one year.

Bloomberg Barclays US Agency Index represents publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government.

Bloomberg Barclays US MBS Index measures the performance of investment grade fixed-rate mortgage-backed pass-through securities of GNMA, FNMA, and FHLMC.

Bloomberg Barclays US Aggregate Bond Index is a broad-based benchmark that measures the investment-grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasurys, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid adjustable-rate mortgage pass-throughs), asset-backed securities, and commercial mortgage-backed securities.

Bloomberg Barclays Municipal Bond Index is considered representative of the broad market for investment-grade tax-exempt bonds with a maturity of at least one year. Bonds subject to the alternative minimum tax or with floating or zero coupons are excluded.

Bloomberg Barclays US Treasury Index represents the US Treasury component of the US Government index. Bloomberg Barclays US Treasury 5-7 Year Index measures the performance of government bonds issued by the U.S. Treasury with maturities of 5-7 years.

Bloomberg Barclays US Credit Index measures the performance of the investment grade corporate debt and agency bonds that are dollar denominated and have a remaining maturity of greater than one year.

Bloomberg Barclays Global Treasury Index is the Treasurys component of the Bloomberg Barclays Global Aggregate Index. Constituents must be rated investment-grade (Baa3/BBB or higher) by at least two of the following ratings agencies: Moody’s, S&P, Fitch.

Bloomberg Barclays Municipal High Yield Index is an unmanaged index of municipal bonds with the following characteristics: fixed coupon rate, credit rating of Ba1 or lower or non-rated using the middle rating of Moody’s, S&P, and Fitch, outstanding par value of at least $3 million, and issued as part of a transaction of at least $20 million. In addition, the bonds must have a dated-date after December 31, 1990 and must be at least one year from their maturity date.

Bloomberg Barclays High Yield Corporate Index is a rules-based, market-value-weighted index engineered to measure publicly issued non-investment grade USD fixed-rate, taxable and corporate bonds.

Bloomberg Barclays Taxable Municipal Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market.

The S&P 500® Index is widely regarded as the standard index for measuring large-cap U.S. stock market performance.

Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

Russell 2000 Index is a small-cap stock market index of the bottom 2,000 stocks in the Russell 3000 Index.

NASDAQ Composite Index is a broad-based capitalization-weighted index of stocks in all three NASDAQ tiers: Global Select, Global Market and Capital Market.

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