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MARKET UPDATE

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Muni bond myths and realities: Bonds are trading, leverage isn't bad, and widespread defaults don't look likely

Following a long, unprecedented period of stability and price appreciation, municipal bond funds experienced equally unprecedented volatility and outflows in early March as the COVID-19 pandemic, broader market selloff and economic uncertainty led investors to hit the panic button. Although municipal markets have begun to stabilize and recover amid massive monetary and fiscal stimulus, many investors are asking questions about the health of the market that reflect not only fear, but also misunderstanding of the factors that drive munis and the performance difference that skilled, active management can provide. Here we address some of these myths and offer insight into our approach to the markets.

Insights from

Nuveen's Municipal Investment Team

MYTH: MUNICIPAL BONDS CAN'T BE TRADED IN A "BAD MARKET."

For sure, market liquidity started to evaporate across credit markets in early March as the crisis took hold. Municipal bonds were hit especially hard, as many individual investors engaged in panic selling of anything liquid to raise cash. We saw a similar liquidity crunch during the 2008 financial crisis. At no time, though, did municipal markets completely freeze. Liquidity remained available, and bonds continued to be bought and sold—just at lower prices due to increased selling pressure. Nuveen continued to engage in competitive selling and buying in all our municipal bond strategies to manage liquidity and capture opportunities.

MYTH: GENERAL OBLIGATION BONDS WILL FACE WIDESPREAD DEFAULTS DUE TO A SHARP RECESSION.

Two pieces of good news here. First, cities and states were in very strong financial shape before the current crisis hit (certainly in better shape than before the 2008 financial crisis). Second, the recent $2 trillion federal stimulus package includes payments to cities and states that issue municipal bonds, which should help provide broader financial stability. Defaults by GO issuers are very rare, but they do happen. This makes careful credit research critical when constructing portfolios.

MYTH: EQUITY DOWNTURNS WILL MEAN PENSION SHORTFALLS.

Pension underfunding (including public pension underfunding) is a serious issue. And it is true that when markets go south, some pension plans might have more difficulty meeting their obligations. But it's a stretch to suggest that these are massive, widespread issues. And it's even more a stretch to suggest that an equity market downturn will translate into broad pension shortfalls that will cause cities and states to default on their bonds. Of course, this does happen in isolation, but history shows us that these tend to be idiosyncratic events. Yet again, this is a case where the "know what you own" mantra rules.

MYTH: PROJECT REVENUE BONDS ARE INHERENTLY HIGH RISK.

Most project revenue bonds are backed by projects that are critically important to supporting Americans' daily activities, such as hospitals, toll roads and airports. Many of these issuers are likely to face pressure given the ongoing slowdown in economic activity, but, as with GO bonds, many of the issuers of revenue bonds will be direct or indirect beneficiaries of the stimulus measures. Also, the same goes for the importance of credit research: Not all issuers are the same, and careful scrutiny is required when selecting bonds.

MYTH: NON-RATED BONDS ARE ILLIQUID AND CAN'T BE PRICED.

This is simply not true. By definition, non-rated bonds are not covered by ratings agencies, but asset managers who include non-rated bonds in client portfolios typically have them priced on a daily basis by outside pricing services. And they are traded the same way as any other bonds—by having buyers and sellers agree on a price. Additionally, it's important to point out that non-rated bonds have experienced price declines similar to rated bonds, but have not been experiencing significant defaults. Our experience suggests owning these bonds through a strategy overseen by a manager who performs careful and ongoing research and due diligence may provide meaningful opportunities beyond those offered by rated securities.

MYTH: LEVERAGE CAUSES SOME FUNDS TO BE PRONE TO UNDERPERFORMANCE.

Leverage is often misunderstood. It is a common tool used by many funds—including most high yield municipal bond funds—in which short-term borrowing is used to purchase longer-term bonds. In normal market conditions, the long-term bonds yield more than the short-term borrowing rate. During the height of the current crisis, however, short-term rates spiked amid the broader liquidity crunch (specifically, SIFMA rates increased inordinately), which turned the normal yield relationship on its head. So investments that were leveraged experienced heightened price declines. We have already seen short-term rates start to come down, however, and expect that trend to continue as the Federal Reserve expands its lending facilities and more investors return to the markets.

MYTH: SHARP DOWNTURNS MEAN FORCED SELLING FOR FUND MANAGERS.

This is related to the myth above. When financial markets decline, fund managers must have a strategy to handle redemptions. Some of this is typically done through cash holdings, some through selling positions that have appreciated in value and some through proportional selling of other positions. Often, this selling is associated with unwinding of leverage to keep funds stable and managed within stated guidelines. This is a normal part of fund management, just as is adding to positions, deploying cash and raising leverage when managing inflows. The truth is that any fund manager worth his or her salt is always prepared for volatility and has a strategy to handle ongoing inflows and outflows.

MYTH: ALL HIGH YIELD MUNICIPAL BONDS ARE HIGH RISK INVESTMENTS.

Our experience suggests this is not the case. Most issuers of high yield debt are very similar in terms of financial stability to the issuers of investment grade debt. Likewise, the specific projects that are backing high yield debt are essentially the same as those backing investment grade debt. The main difference tends to be that issuers of high yield debt are newer to the marketplace, and investors require an extra premium to purchase their bonds. Over time, most issuers of high yield debt evolve into issuers of investment grade debt.

MYTH: HIGH YIELD MUNICIPALS HAVE THE SAME RISK PROFILES AS HIGH YIELD CORPORATE BONDS.

It's understandable why some investors might believe this, since both assets are rated by ratings agencies, and, on the surface, one could imagine that a lower-rated municipal bond has the same inherent risks as a lower-rated corporate bond. But even a casual look at default rates show that is not true: Across the credit spectrum, municipal bonds have historically experienced lower default rates than corresponding corporate bonds. And the main drag on high yield corporate bonds today (the massive collapse in energy prices) doesn't have anywhere near the same effect on municipal bonds.

MYTH: DURATION IS THE ONLY FACTOR THAT DETERMINES MARKET PERFORMANCE.

Duration is important to any fixed income investment. But in our experience, credit research makes the most difference in municipal bond investing. Even at the best of times, the municipal market is fragmented, idiosyncratic and inefficient. Covering the vast array of issuers across states, territories, cities, projects and types of bonds requires a massive amount of experience, skill and resources. We have said it before, but it's worth saying again: Investing in municipal bonds requires a careful and thorough approach to credit research.

MYTH: YOUR WRAPPER DOESN'T MATTER: MUNICIPAL OPEN-END FUNDS, CLOSED-END FUNDS, SEPARATELY MANAGED ACCOUNTS AND ETFS ARE ALL THE SAME.

This one is patently untrue. Each vehicle is designed for different purposes: some to track an index, some to seek outperformance, some to take on more leverage, some to benefit from less liquidity and all designed to seek different outcomes for different investors.

A couple of specific points are also worth pointing out. First, in our experience, ETF performance is not a leading indicator for all investments. Vehicles that are not designed to track an index often perform very differently. After all, that's why they exist in the first place. Second, investments across different complexes are often constructed very differently. For example, many funds that are labeled as "high yield municipal bond funds" actually hold more investment grade bonds than they do high yield bonds.

We'll close with a point we included above: Know what you own.

For more information, please contact visit us at nuveen.com.

Endnotes

Sources

Bloomberg, L.P.; U.S. Municipal Bond Defaults and Recoveries, 1970 –2018, Moody's Investors Service.

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Investing involves risk; principal loss is possible. All investments carry a certain degree of risk and there is no assurance that an investment will provide positive performance over any period of time. Investing in municipal bonds involves risks such as interest rate risk, credit risk and market risk. The value of the portfolio will fluctuate based on the value of the underlying securities. There are special risks associated with investments in high yield bonds, hedging activities and the potential use of leverage. Portfolios that include lower rated municipal bonds, commonly referred to as "high yield" or "junk" bonds, which are considered to be speculative, the credit and investment risk is heightened for the portfolio. Bond insurance guarantees only the payment of principal and interest on the bond when due, and not the value of the bonds themselves, which will fluctuate with the bond market and the financial success of the issuer and the insurer. No representation is made as to an insurer's ability to meet their commitments. This information should not replace an investor's consultation with a professional advisor regarding their tax situation. Nuveen Asset Management is not a tax advisor. Investors should contact a tax advisor regarding the suitability of tax-exempt investments in their portfolio. If sold prior to maturity, municipal securities are subject to gain/losses based on the level of interest rates, market conditions and the credit quality of the issuer. Income may be subject to the alternative minimum tax (AMT) and/or state and local taxes, based on the state of residence. Income from municipal bonds held by a portfolio could be declared taxable because of unfavorable changes in tax laws, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

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