Liquidity Management Is Critical

Insights from MacKay Municipal Managers

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From **MacKay Municipal Managers™**
The Minds Behind Munis

Key Takeaways

- Municipal market liquidity is secularly challenged by a reduction in bond insurance, declining institutional participation and investor uncertainty.
- Liquidity risk arises from the mismatch between the liquidity of the product or strategy and that of the market, and this mismatch becomes greater during periods of dislocation.
- Volatility presents opportunities for those who manage liquidity properly.

Liquidity management is a critical, yet often overlooked feature of an actively managed approach. As part of their due diligence, investors should give stronger consideration to managers with prudent, well-thought-out liquidity management practices. The right approach to this may help manage volatility, but it may also generate total return opportunities. The municipal bond market has long been fragmented, complex and less liquid than other fixed income markets. In a market like this, we believe active management can capitalize on the numerous inefficiencies created by these conditions.

Secular Challenges to Municipal Market Liquidity

We have identified three key factors that may impede liquidity:

1. A reduction in bond insurance.

New issues wrapped by insurers have declined significantly, from 60% in 2007 to less than 10% in 2022[1]. Historically, the attributes of insured bonds contributed to their better relative liquidity. Whereas investors could once select from a larger pool of insured bonds designed to provide additional protection from default, investors must now seek in-depth credit analysis. As a result, professional guidance is necessary to identify the more liquid parts of the municipal bond market more than ever before.

2. A decline in institutional participation.

New regulations, tax changes, and competing investment products have led broker-dealers to reduce the amount of capital they commit to municipal trading. In addition, the tax reform legislation of 2017 has also caused commercial banks to reduce their exposure to the municipal market. As a result of this reduction in institutional involvement in the municipal market, the relative liquidity of the municipal market has been negatively impacted.

3. Investor uncertainty has increased.

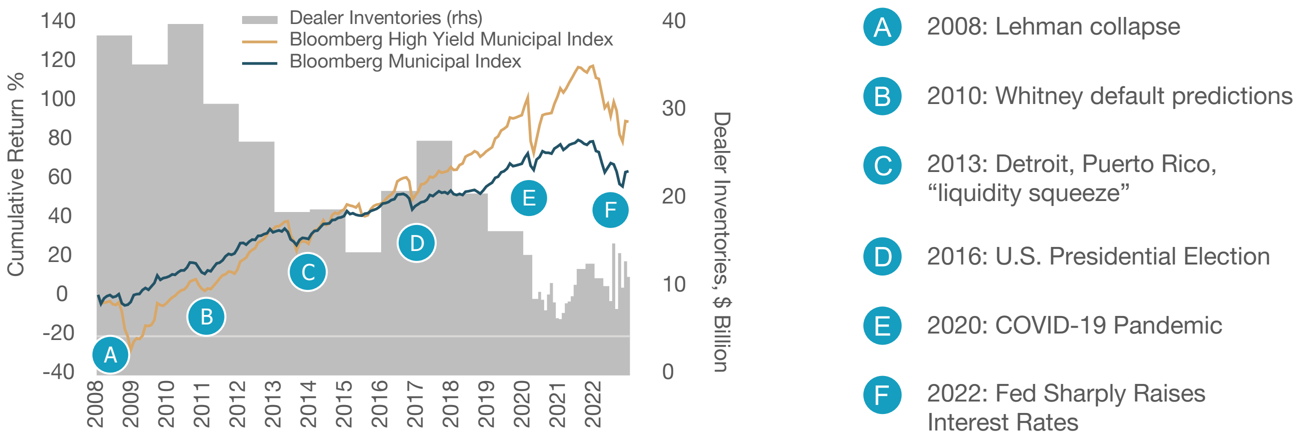
Ongoing individual investor migration to the intermediate portion of the municipal yield curve suggests an increasing concern with market risk. Uncertainty over rising interest rates and municipal credit conditions have driven this "flight to quality" trade.

[1] Source: According to market data from bondbuyer.com.

However, while experienced municipal managers recognize that uncertainty contributes to illiquidity, it can also generate opportunities to capture value.

Several events illustrate this volatility: market reactions to a widely circulated prediction in 2010 of imminent and widespread muni defaults, headlines regarding the finances of Detroit and Puerto Rico in 2013, the Presidential election 2016, the COVID-19 pandemic and the Federal Reserve sharply raising interest rates were all severe. The technical selling pressure following these events produced significant drawdowns (and opportunities through active management).

Drawdowns became more significant as broker-dealer inventories declined.



Past performance is not indicative of future results. It is not possible to invest in an index. Events referenced on timeline are not necessarily the sole cause of market declines during the periods highlighted. Sources: Bloomberg and U.S. Federal Reserve, as of December 2022. See disclosures for index descriptions.

Why Liquidity Management?

In our view, this new municipal bond landscape can be navigated best via active management, and one of the core pillars of an active approach is liquidity management. Liquidity risk arises from the mismatch between the liquidity of the product or strategy and that of the market, and this mismatch becomes greater during periods of dislocation.

MacKay Municipal Managers™ Believe That Liquidity is Best Managed by:

Omitting mutual fund leverage — In our opinion, leverage should not be employed in municipal bond mutual funds. We believe it contributes to portfolio illiquidity in a "daily-access" vehicle and may add interest rate sensitivity to the portfolio. This may be of particular concern when added to a high yield municipal fund where the client objective is to gain exposure to lower-rated, higher-yielding credits while minimizing rate sensitivity.

Maintaining a cash cushion — Whereas before the crisis, a municipal mutual fund could operate comfortably with 1% cash, we believe today that reserve should be 3-8%. A slightly lower yield resulting from a large cash position is a reasonable price to pay to avoid becoming a forced seller during a dislocation, plus, an active manager will be well-positioned to capitalize along the way.

- **Limiting non-rated bonds —** Fund managers should also limit their holdings of non-rated bonds. Because not all buyers are willing to buy these issues, non-rated issues effectively reduce liquidity.
- **Focusing on diversification —** Municipal fund managers should also place limits on the allocations they make to individual obligors. These caps force the fund to diversify across more names, which reduces the chance of having to be a forced seller of any particular one.
- **Capitalizing on bond structure —** Managers should also consider bonds with coupon and call structures. In effect, call option characteristics can lower a bond's duration, limiting its downside in a difficult market. These bonds hold up better in a dislocation as they are easier to sell, which therefore helps boost a fund's liquidity.

The reduction in market liquidity presents risk to municipal bond investors because it can produce significant market dislocations. But there is also an upside: we maintain today's new level of volatility is largely a result of technical factors, not fundamentals. As a result, it also presents opportunities for those who manage liquidity properly seeking to avoid becoming forced sellers during a drawdown.

Municipal securities 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. Such uncertainties could cause increased volatility in the municipal securities market and could negatively impact the Fund's net asset value and/or the distributions paid by the Fund. Securities purchased by the Fund that are liquid at the time of purchase may subsequently become illiquid due to events relating to the issuer of the securities, market events, economic conditions, or investor perceptions.

Liquidity risk is the risk that certain securities may be difficult or impossible to sell at the time that the seller would like or at the price that the seller believes the security is currently worth. The Fund may not be able to pay redemption proceeds within the allowable time period because of unusual market conditions, unusually high volume of redemptions, or other reasons. To meet redemption requests, the Fund may be forced to sell securities at an unfavorable time and/or under unfavorable conditions.

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

This material represents an assessment of the market environment as at a specific date; is subject to change; and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research or investment advice regarding the funds or any issuer or security in particular.

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Definitions:

Active management is the use of a human element, such as a single manager, co-managers or a team of managers, to actively manage a fund's portfolio. Active management strategies typically have higher fees than passive management.

Bloomberg Municipal Bond Index: A rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a date-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark. The index has four main sectors: general obligation bonds, revenue bonds, insured bonds (including all insured bonds with a Aaa/AAA rating), and prerefunded bonds. Most of the index has historical data to January 1980. In addition, sub-indices have been created based on maturity, state, sector, quality, and revenue source, with inception dates later than January 1980.

Bloomberg Municipal High Yield Index: 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 U.S. Taxable Municipal Index: The Bloomberg U.S. Taxable Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies if all three rate the bond: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate and must be at least one year from their maturity date. Remarketed issues (unless converted to fixed rate), bonds with floating rates, and derivatives, are excluded from the benchmark.

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Past performance is not indicative of future results.