INVESTMENT INSIGHTS

A golden opportunity: California municipal bonds

MAY 2023

From MacKay Municipal Managers

The Minds Behind Munis

Overview

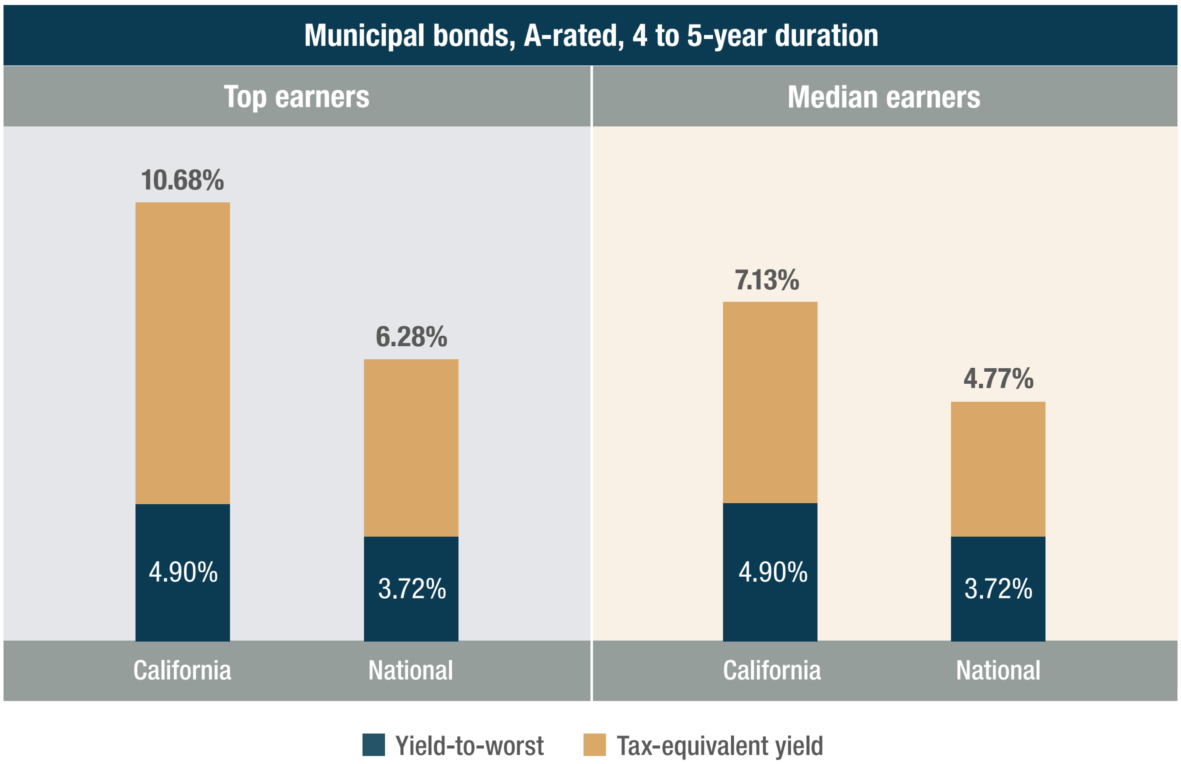
California municipal bonds delivered value to investors by providing both tax-free income[1] where applicable and strong relative performance compared to the broader municipal market over the ten year period ending March 31, 2023.

While the municipal bond market provides investors with tax-free income potential across the nation, state-focused investment strategies currently present a compelling opportunity for residents of states with high tax rates, strong demand due to high concentrations of wealth, diverse issuance, and sound long-term credit fundamentals. We believe California fits this profile, particularly with respect to tax rates and wealth levels. Importantly, California municipal bonds have benefited from strong relative performance compared to the overall municipal market over the ten year period ending March 31, 2023. When building municipal portfolios, in our view, it is important that California residents consider taking advantage of in-state bonds and consider a state-focused investment strategy.

Strong demand originates from economic strength, wealth concentration, and high tax rates

California has the highest GDP in the United States and is the fifth largest economy in the world.[2] San Francisco and Los Angeles are listed among the top ten largest cities worldwide by ultra-high net worth population (UHNW), defined as individuals worth at least $30 million.[3] Additionally, San Francisco is home to the second highest density of billionaires in the world, just behind Kuwait City and ahead of Hong Kong.[4] This type of wealth concentration makes California's municipal offerings attractive for its residents, but the wealthy are not the only beneficiaries. The median household income in the state is $81,575[5] and faces a top marginal state tax rate of 9.3% — greater than the top tax rates of 47 U.S. states and territories. The tax rate within California for the top tier of earners is 13.3%, driving consistent demand for in-state municipal bonds. In **Figure 1**, we can see that California municipal bonds offered an attractive tax-equivalent yield to both top and median earners.

Figure 1: California munis offer compelling tax-equivalent yields — and not just for top earners[6]



Source: ICE Data.

The California market is diverse

The California municipal market is sufficiently diverse that, in our view, one does not need to give up the benefit of its in-state tax exemption to manage risk. At $657 billion, California is the largest state in the municipal market and represents approximately 17% of the $3.98 trillion overall market.[7] Furthermore, we believe experienced active managers can unlock many opportunities not readily apparent to the average investor. California consists of 58 counties, 482 municipalities, and 1,037 school districts,[8] generating a wide range of issuers and constant supply of new issuance. California bonds accounted for 15% of new issue supply in 2022.[9] We think that robust new issue supply creates a fertile environment for relative value trading[10] and security selection. Furthermore, even though the California municipal market boasts about twice the number of securities than the entire U.S. corporate bond market, relatively few California munis are traded on a daily basis. Those that are frequently traded originate from a limited set of issuers, which helps create additional relative value opportunities.

California has sound credit fundamentals

From a credit perspective, the state of California remains highly rated (Aa2/ AA-/AA)[11] with strong reserves projected to exceed $37B in fiscal year 2023 and declining debt and retirement liabilities.[12] The state is closely monitoring projected tax collection declines and has identified tools at its disposal to address potential shortfalls, including spending adjustments, without using the state's large accumulated reserves. Given its large and diverse economic base, we believe that the state is well-positioned to withstand a moderate economic downturn given its considerable accumulated reserves as well as strong access to the capital markets and its ability to adjust budgets. In **Figure 2**, we can see that historically, municipal debt with California's rating has had negligible default risk, especially when compared to corporate bonds of the same rating.

Figure 2: Muni default risk is historically low

Historical default rates: municipal vs. corporate bonds

Cumulative default rates (%)		S&P		MOODY'S	
		Municipal*	Corporate**	Municipal***	Global Corporate***
Investment grade	Aaa / AAA	0.00	0.83	0.00	0.35
	Aa / AA	0.03	0.98	0.02	0.76
	A / A	0.08	1.69	0.10	1.96
	Baa / BBB	0.73	4.01	1.06	3.45
Below investment grade	Ba / BB	3.93	13.69	3.40	14.78
	B / B	10.78	25.66	16.70	33.42
	Caa-C / CCC-C	36.52	56.48	23.71	49.04

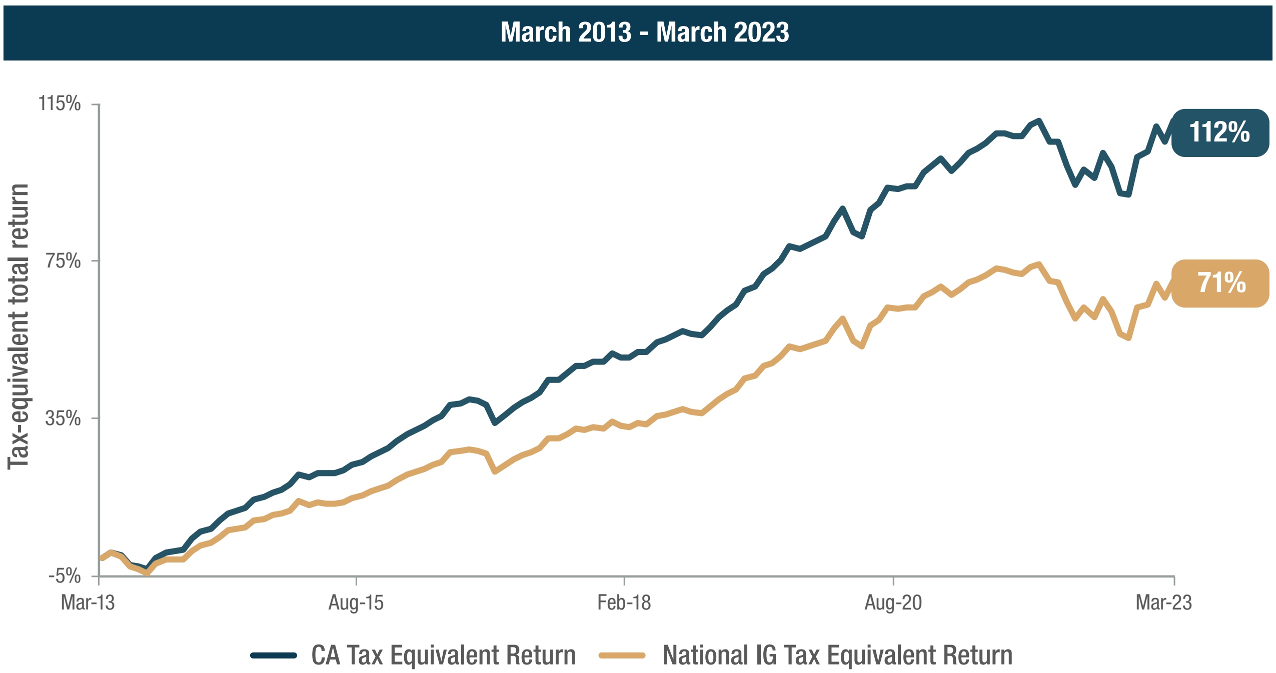
*Moody's Investor Service, U.S. Municipal Bond Defaults and Recoveries, 1970-2021 (Corporate Ratings Represent Global Corporates) **S&P USPF Cumulative Average Default Rates 1986-2021 ***S&P U.S. Corporate Average Cumulative Default Rates 1981-2021. Past performance is no guarantee of future results.

Source: ICE Data.

California's historical outperformance versus the broader national municipal market

In our view, in-state investors should take comfort that California municipal bonds possess the same characteristics that make the broader national marketplace so appealing: tax-exempt income where applicable,[14] low default risk, and portfolio diversification. However, returns for California muni investors have significantly exceeded the national index over the past decade. On a tax-equivalent basis, California municipals generated a cumulative total return of 112% versus just 71% for the broader national market over that same 10-year period, as shown in **Figure 3** below.

Figure 3: California municipals provided significant upside for in-state investors[13]

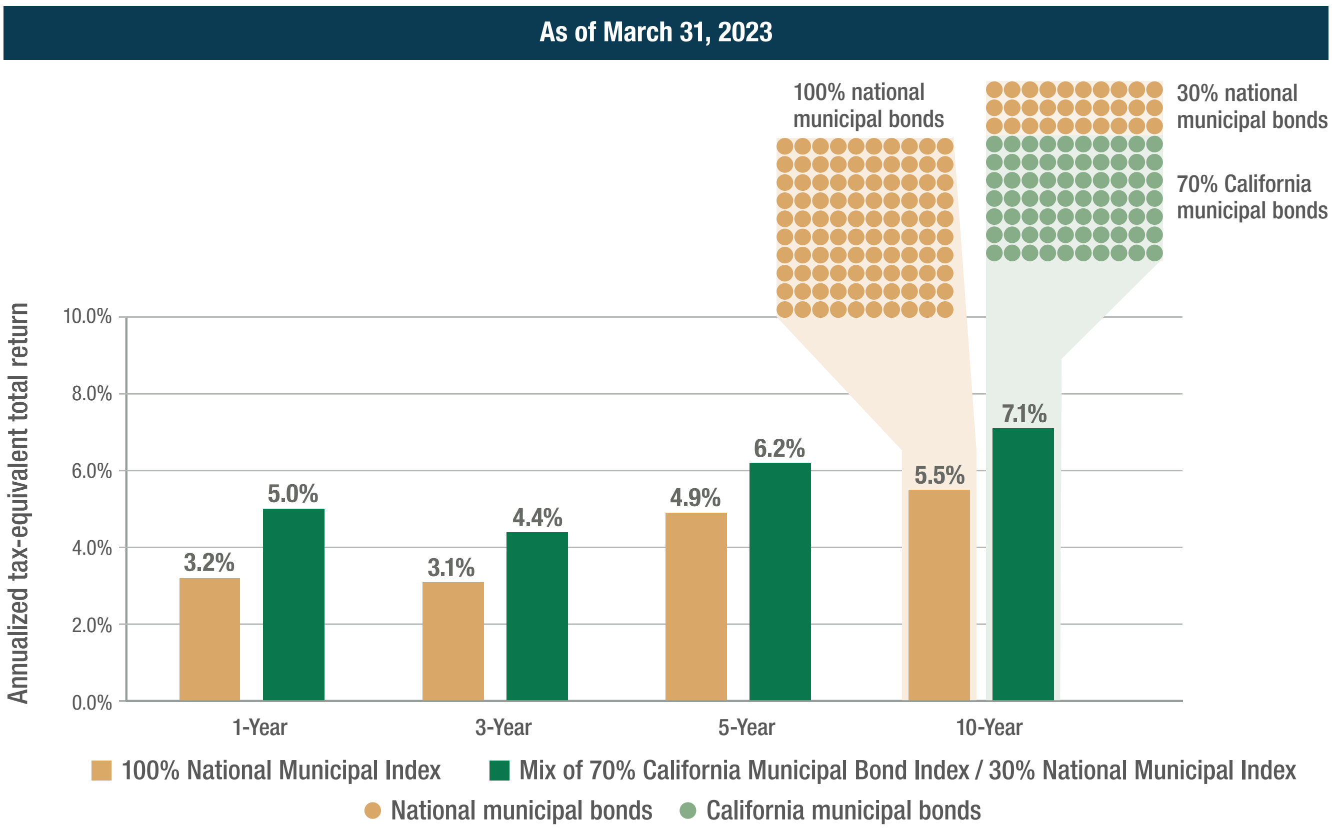


Data as of March 31, 2023.
Source: Bloomberg, Morningstar.

Now, consider the performance of the National Municipal Index relative to a blend of 70% California Municipal Index and 30% National.

Based on annualized tax-equivalent total return, the California-focused blend outperformed the National Index by an average of 1.48% annualized across the trailing 1-, 3-, 5-, and 10-year periods for the period ending March 31, 2023. (See Figure 4 below)

Figure 4: Annualized tax-equivalent total return[14]



Data as of March 31, 2023.
Source: MacKay Shields, Bloomberg, Morningstar.

We believe an active strategy is essential when seeking to unlock value within the California municipal market

We believe that an active, opportunistic investment approach has the potential to generate competitive outcomes for California investors. To understand why, it may help to take a step back and examine the broader municipal marketplace.

The nature of the municipal bond market creates an environment that is rife with inefficiencies. A staggering amount of issuers and distinct securities (1 million+ CUSIPs) have created a widely dispersed market that challenges investors seeking to conduct credit research and price discovery. Differences in state tax codes can cause variances in supply and demand technicals that further complicate the investment analysis and assessment of relative value. In our opinion, heavy participation by the average individual investor also contributes meaningfully to the inefficiencies observed in the market.

The California market is no different and often presents skilled active managers with similar opportunities. By design, we maintain that the traditional laddered, buy-and-hold approach to muni investing cannot take advantage of compelling, but fleeting, opportunities when they arise. Therefore, we believe that our approach, which seeks to identify relative value across the entire California landscape, and is rooted in fundamental, bottom-up credit research, may help generate better outcomes.

Golden opportunity

We believe the California market will likely continue to benefit from several tailwinds, including healthy state fundamentals and economic strength. High state taxes are poised to keep demand strong, and a large new issue supply ensures plenty of new investment opportunities. Finally, the historical performance of California municipal bonds cannot be ignored. These factors lead us to believe that a state-focused California municipal bond strategy should be considered for California residents seeking tax-free income.[14]

> *"Faced with one of the highest state income tax rates in the nation, California investors continue to demand tax-efficient fixed income strategies. With a West Coast presence, we are able to reach and serve these clients even more effectively."*
>
> *—John Loffredo, Co-head of MacKay Municipal Managers™*

Active management, with a local presence

MacKay Municipal Managers™ (MMM) is a recognized leader in active municipal bond investing and is entrusted with more than $68 billion in assets under management, as of March 31, 2023. Team members average over 20 years of industry experience, and its co-CIOs have worked together since 1993.

MMM uses an active, opportunistic approach to manage portfolios. With deep credit and relative value analysis as the cornerstone of the process, MMM actively seeks the most compelling segments of the yield curve and credit spectrum – all with the goal of capitalizing on inefficiencies in the marketplace.

The team's commitment to the California municipal market is reflected by their local presence in California. Since 2016, MMM has had a Los Angeles office. Today, the LA investment team includes portfolio management, trading, credit research, and client service.

MacKay Municipal Managers, LA Office

PORTFOLIO MANAGEMENT & TRADING

Robert Dimella, CFA—Executive Managing Director, Co-Head of MMM

Peter Bartlett—Senior Managing Director, Portfolio Manager

Scott Sprauer—Senior Managing Director, Portfolio Manager

Michael Denlinger, CFA—Director, Portfolio Manager/Trader

Sanjit Gill, CFA—Director, Trader

CREDIT RESEARCH

Ian France, CFA—Director, Research Analyst

Alex McLaughlin, CFA—Director, Research Analyst

CLIENT SERVICE

Bruno Machado—Managing Director, National Head of Family Offices

Eric Snyder—Director, Client Portfolio Manager

Megha Shrimal—Director, Client Portfolio Manager

FOR MORE INFORMATION

Visit **muni360.com** or call **888-474-7725** for more about MacKay Municipal Managers and how California municipal bonds can help in-state investors today.

1. Not to be construed as tax advice. Investors should consult their tax advisors for individualized guidance.
2. World Bank, Bureau of Economic Analysis. Based on 2020 annual GDP.
3. *World Ultra Wealth Report 2022.* Wealth-X.
4. 2022 Billionaire Census. Wealth-X.
5. *U.S. Census Bureau, Median Household Income in California* [MEHOINUSCAA646N], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MEHOINUSCAA646N, March 31, 2023.
6. CA top earners' tax rate includes 37% federal, 3.8% net investment income tax, and 13.3% state income tax (12.3% state tax rate +1% CA mental health services tax for incomes over $1 million). CA median earners' tax rate includes 22% federal and 9.3% state. National top earners' tax rate includes 37% federal and 3.8% net investment income tax. National median earners' tax rate includes 22% federal. Median earners' assumes a single filer with income of $81,575, the most recently reported CA household median income level. California Municipal Bonds are represented by ICE BofA California Municipal Bond Index as of March 31, 2023. National Municipal Bonds are represented by ICE BofA US Municipal Index. **Past performance is not a guarantee of future results, which will vary**. It is not possible to invest in an index. The returns shown above do not represent the returns of any fund, client portfolio or strategy actually managed by MacKay Shields and should not be construed as such. The returns shown are index-based; MacKay Shields' portfolios are actively managed and would vary from any applicable index. Actual portfolios would be subject to fees and expenses. No fees or expenses were included in the above results. The above example is shown for illustrative purposes only. Please see "Tax Equivalent Yield" disclosure at the end of this document. Nothing herein should be construed as tax advice. Consult your tax advisor for individualized guidance. See disclosures at the end of this document for index definitions.
7. Bloomberg as of April 2023.
8. *Census of Governments*. U.S. Census Bureau. As of 2017 (most recent available)
9. Bloomberg, SIFMA as of April 2023.
10. MSRB, SIFMA as of December 31 ,2022. In 2022 secondary market avg daily trading volume for CA municipals was $1.3 billion vs $40.2 billion for U.S. corporates.
11. Bloomberg as of April 2023.
12. Source: State of California website. The state reports that it has taken action to reduce its long term liabilities, through paygo capital expenditures as well as legislation that requires excess capital gains taxes to be used to pay down long term pension liabilities. California's Proposition 2, passed in 2014, requires a transfer of capital gains tax in excess of 8% of general fund revenue, split between a budget stabilization fund, which is now projected to rise to its cap of 10% of revenue, and an extra paydown of long-term liabilities. The state projects paydowns of unfunded other postemployment benefits (OPEB) and pension liabilities through fiscal 2027 amounting to a modest 1%-2% per year of total unfunded liabilities. The FY 2024 budget continues paydown of state retirement liabilities required by Prop 2, $1.29B in additional payments.
13. Tax-equivalent total returns based on adjustment of coupon income, compounded monthly. Calculation reflects historical changes to the maximum federal and CA state income tax rates. Maximum federal tax rate was 35% in 2012, 39.6% from 2013-2017, and 35% from 2018-present. Maximum CA state income tax rate was 10.3% in 2012 and 13.3% from 2013-present. 2013-present includes 3.8% net investment income tax. California Municipal Bonds represented by Bloomberg California Municipal Bond Index. National Municipal Bonds represented by Bloomberg Municipal Bond Index. **Past performance is not a guarantee of future results, which will vary.** It is not possible to invest in an index. The returns shown above do not represent the returns of any fund, client portfolio or strategy actually managed by MacKay Shields and should not be construed as such. The returns shown are index-based; MacKay Shields' portfolios are actively managed and would vary from any applicable index. Actual portfolios would be subject to fees and expenses. No fees or expenses were included in the above results. The above example is shown for illustrative purposes only. Please see "Tax Equivalent Yield" disclosure at the end of this document. Nothing herein should be construed as tax advice. Consult your tax advisor for individualized guidance. See disclosures at the end of this document for index definitions.
14. Not to be construed as tax advice. Investors should consult their tax advisors for individualized guidance.

About risk

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. Securities 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.

Bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner. A portion of the municipal bond's income may be subject to state and local taxes or the alternative minimum tax. Events in California, including fiscal or political policy changes, tax base erosion, and state constitutional limits on tax increases, budget deficits, and other financial difficulties, are likely to affect investments in municipal bonds issued by or on behalf of the State of California and its political subdivisions, agencies, and instrumentalities. California may experience financial difficulties due to the economic environment. Any deterioration of California's fiscal situation and economic situation of its municipalities could cause greater volatility and increase the risk of investing in California.

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. **Credit Ratings:** S&P rates borrowers on a scale from AAA to D. AAA through BBB represents investment grade, while BB through D represents non-investment grade. Moody's rates borrowers on a scale from Aaa through C. Aaa through Baa3 represents investment grade, while Ba1 through C represents non-investment grade. **Duration** is a measure of the sensitivity of the price of a bond to a change in interest rates. **Yield to Worst** is the lowest potential yield that can be received on a bond without the issuer actually defaulting and is calculated by making worst-case scenario assumptions on the issue by calculating the return that would be received if the issuer uses provisions, including prepayments, calls, or sinking funds. Index results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index. **Distribution yield** is the ratio of all the distributions a fund paid in the past 12 months divided by the current share price of the fund. **Muni treasury ratio** is computed by dividing a given municipal bond's yield by the yield on a comparable maturity Treasury security. The yield ratio curve is an array of ratios for given maturities, typically 1 to 30 years. **Bloomberg 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 California Municipal Bond Index** is a market value-weighted index of California investment-grade, tax-exempt, fixed-rate municipal bonds with maturities of one year or more. **ICE BofA Municipal Bond Index** tracks the performance of large capitalization U.S. denominated investment-grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. **ICE BofA California Municipal Index** tracks the performance of California investment-grade tax-exempt municipal bonds with maturities of one year or more.

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