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Complementing the Core

MacKay team plies the taxable muni market.

UNDISCOVERED MANAGER

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Undiscovered Manager profiles noteworthy strategies that aren't covered by Morningstar Research Services' analyst team.

When investors think of municipal bonds, the first thing that comes to mind is usually the phrase *tax-exempt*.

The benefit of income free from federal—and potentially state—taxes is obvious. But there are other advantages. For the most part, issuers of municipal bonds also have strong credit profiles, lower default histories, and lower volatility than issuers of corporate bonds. They add an edge to a diversified strategy with their low correlations to many other corners of the bond market.

Still, muni bonds' tax-exempt association means most investors consider them in a separate bucket than the rest of a traditional taxable-bond portfolio.

That's the kind of thinking that the managers of the $582 million MainStay MacKay US Infrastructure Bond Fund MGOIX are looking to change. They have a good case: The fund, which invests primarily in taxable muni bonds and lands in the intermediate core bond Morningstar Category, has come out ahead of most of its category peers since the start of its current strategy in February 2019. Run by municipal-bond specialists at MacKay Shields, a unit of New York Life, the fund has returned an annualized 1.28% through March, well ahead of the 0.23% average annual return for the category.

AComplement to Core Bonds

"It is a very interesting strategy to complement an investor's core bond allocation," says Morningstar analyst Paul Olmsted. "While the taxable municipal-bond market is relatively small, this fund's infrastructure investments may appeal to a certain part of the market and remain competitive on performance."

Taxable municipal bonds are generally offered by the same state and local governments, agencies, and institutions that issue the tax-exempt debt most investors associate with munis. But the U.S. tax code limits the amount of debt an issuer can come to market with and imposes strict regulations on the use of those bond proceeds. As a result, these issuers, when looking to raise funds, will sometimes come to market with taxable debt.

Taxable debt was a very small portion of the muni-bond market until 2009, when in the wake of the financial crisis, the Build America Bonds program was launched to help lower borrowing costs for state and local governments. Although the program ended in 2010, it generated interest in the market among institutional investors. When the rules governing the ability of issuers to refinance taxable debt were tightened starting in 2018, the market saw another jump in issuance. Today, taxable debt represents $840 billion, or 21% of the $4 trillion muni market.

The MacKay U.S. infrastructure bond fund is team-managed by MacKay Municipal Managers, a group that has its origins in the fixed-income department at Merrill Lynch Investment Managers, before it was acquired by BlackRock. The co-chief investment officers of MacKay Municipal Managers, John Loffredo and Robert DiMella, have worked together since 1993.

At the helm of the infrastructure fund is Scott Sprauer, who joined MacKay Shields in 2009, and Robert Burke, who came on in 2017. Both have several decades of experience in the capital markets. Portfolio manager Sanjit Gill started with MacKay Shields in 2021. Also on the team is Michael Denlinger, a portfolio manager who focuses on strategies that invest in both taxable and tax-exempt municipal bonds.

Leveraging Tax-Exempt Research

The strategy focuses on taxable muni debt, but because the issuers are largely the same as in the tax-exempt market, the team has access to the research done for the tax-exempt portfolios at MacKay Municipal Managers, which oversees $64 billion. The muni team has eight full-time dedicated research personnel, with six in Princeton, New Jersey, and two in Los Angeles.

The MacKay Shields strategy invests at least 80% of its assets in debt related to municipal infrastructure, with a minimum of 60% of its assets in taxable muni bonds. The fund can also hold up to 20% in tax-exempt debt, although generally the allocation to tax-exempt bonds is in the low single digits.

Even though the fund lands in the intermediate core bond category—where many funds have the Bloomberg U.S. Aggregate Bond Index as a benchmark—the MacKay infrastructure fund is managed against the Bloomberg Taxable Municipal Index. The strategy is focused on bonds in the five- to 10-year portion of the market.

From an income standpoint, the MacKay Shields portfolio carried an SEC yield of 4.3% at the end of January compared with a 3.6% yield on the average intermediate core bond fund.

"The fund delivers corelike performance, generating reliable income and offering diversification benefits to risk assets," says Morningstar's Olmsted.

At MacKay Shields, the focus is on bottom-up securities analysis rather than macro-level bets on interest rates. "We're not really making big duration bets one way or another," says Burke. At any given time, 75% to 80% of the portfolio is invested in line with the benchmark index in terms of credit quality and duration.

But from there, the team will layer on what they refer to as tactical positions. "We'll view trades like putting on tax-exempts or taking them off to generate alpha for the fund, or holding securities outside that five- to 10-year window."

Last year, for example, the team felt there was an opportunity to add to performance by significantly raising the fund's weighting in tax-exempt munis. The catalyst was the record selling of tax-exempt muni bonds by individual investors that pushed yields in that market to wider levels compared with Treasuries, leading to a spread advantage over taxable municipal bonds, where individual investors have less influence.

"We look to the team that are trading tax-exempts all day long and can talk about relative value," says Burke.

In response, during the June and July period, the team raised the fund's weighting in tax-exempt debt to roughly 12.5%, well north of the typical 1% to 2% exposure. As the dislocation in the tax-exempt market ebbed, the team began trimming the tax-exempt exposure, and by year-end, the allocation was down near 7%. While the taxable and tax-exempt markets are the same issuers and the "same high credit quality, the dynamics are different in each market," says Sprauer. "That gives us the ability to take advantage of those dislocations and deliver alpha."

While not making outright interest-rate bets, the team also looks to benefit from opportunities they see along the yield curve. In 2022, as the yield curve was flattening and on its way toward inverting, they tilted toward longer-dated bonds. In addition, the team upped the cash holdings in the fund to a higher level than normal in the February-March period, when it hit a peak around 7%. From there, it averaged roughly

The investment team at MainStay MacKay US Infrastructure Bond Fund: **Michael Denlinger**, director; **Scott Sprauer**, managing director; **Sanjit Gill**, director; and **Robert Burke**, managing director.

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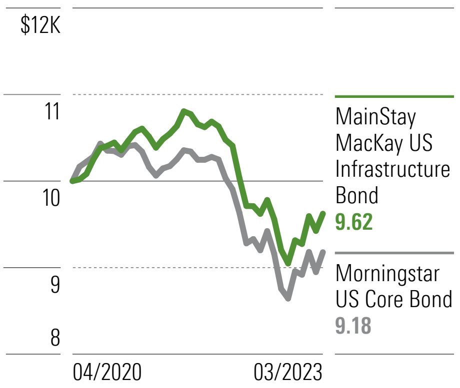
MainStay MacKay US Infrastructure Bond MGOIX

Growth of $10K



Morningstar Category	Interm Core Bond
Morningstar Rating 3-Yr*	★★★★
Expense Ratio (%)	0.60

*Fund adopted current strategy on Feb. 28, 2019.
Source: Morningstar Direct. Data as March 31, 2023.

6% throughout the year. Historically, the fund has tended to hold 2%-3% cash.

Between the tilt toward longer durations and the increased cash holdings, "we had kind of an extended barbell on that benefited the fund," Burke says.

Opportunities in Taxable Bonds

But it's the work on the taxable side of the equation that the MacKay Shields team says separates them from the rest of the pack.

For example, there's their approach to debt issued by healthcare providers both at the individual security level and at the sector level.

At the individual security level, the team points to an October 2020 investment the fund made in bonds from Long Island Community Hospital. The bonds were carrying a relatively low BBB- rating but yielding around 4.9%.

"We thought there was an opportunity for M&A in this particular instance … that it was a natural geographic expansion for one of the larger healthcare systems in New York City," says Burke.

Then in March 2022, a deal was announced that the hospital was being acquired by NYU Langone Health, which carries a stronger credit rating. That led ratings agencies to upgrade Long Island Community Hospital in May. "The total return impact … was pretty substantial," says Burke. As of late February, the fund still held the bonds.

In addition, at the sector level, the fund's performance in 2022 was bolstered by an underweighting in healthcare bonds compared with the fund's benchmark.

"It's not just looking at an individual credit, or a bunch of credits and making a sector call; there's a macro aspect to it," says Sprauer. Healthcare providers are struggling with staffing shortages, and federal reimbursements for hospital care are coming down, he notes. "The post-COVID world looks a little bit different and the stress at the hospital level is showing. So, we're sticking with the larger systems, the strong systems, and getting out of those that have downgrade risk."

Strong Credit Quality

With an eye toward the macro-level risks of a recession, the MacKay Shields team has been more broadly tilting toward more highly rated debt. As of late February, they had raised the fund's allocation to AAA rated debt by 11.5 percentage points from where it stood a year ago and reduced holdings of A rated debt by 7 percentage points. They also took down BBB debt by 6 percentage points.

"We have traded a lot among these credits, or even within the BBB or A credit bucket," says Gill. But with the bottom-up approach, "we're trying to buy the best credits within those buckets."

While the infrastructure fund lost money for the 12 months ended Feb. 21, it's still outperformed most traditional core bond funds. The MacKay Shields strategy lost 8.3% during that period compared with an 8.9% decline on the average core bond fund, leaving it in the 27th percentile for one-year performance. Overall, the team is optimistic about the ability of muni issuers to weather a potential economic slowdown.

"Yes, sales taxes have come down," Sprauer says. "Yes, income taxes will come down and capital gains, but many of the states put money aside post-COVID, with help from federal money and also with the robust consumer economy that we really had." As a result, governments "put a tremendous amount of money into rainy day funds and reserve funds at the state levels and it also filled the coffers. We're going into this potential downturn in much better shape."

Sprauer says that the taxable muni portfolio is well protected against the type of credit quality issues that could dog corporate-bond funds in a recession. "There are a tremendous amount of levers that states can pull if there is some kind of revenue shortfall," he notes.

These are the kinds of dynamics that the MacKay Shields team points to when it comes to the value of the taxable muni strategy.

"We think it's a great either complement to your IG corporate exposure, or substitute through different economic cycles," says Sprauer. "And that's what we're trying to get people to understand, because we do think it has a place in a lot of different types of asset-allocation models." M

Tom Lauricella is chief markets editor for Morningstar.

Photography by David Zentz.

Click on the [MainStay MacKay U.S. Infrastructure Bond Fund] link which includes (as applicable) investment objectives, costs and expenses, liquidity, safety, guarantees or insurance, fluctuation of principal or return, and tax features. The fund's prospectus, standardized fund performance, important risk, and other important information is available by clicking on fund name link. Returns represent past performance which is no guarantee of future results.

Current performance may be lower or higher. Investment return and principal value will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Visit https://www.newyorklifeinvestments.com/mutual-funds/mainstay-mackay-us-infrastructure-bond-fund?ticker=MGOIX for the current fund and performance information.

Before considering an investment in the Fund, you should understand that you could lose money. Mutual funds are subject to market risk and fluctuate in value. An investment in the Fund is not a bank deposit and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other governmental agency. Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk which is the possibility that the bond issuer may fail to pay interest and principal in a timely manner. Municipal bond risks include the inability 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. The Fund's investments in infrastructure-related securities will expose the Fund to potential adverse economic, regulatory, political, legal and other changes affecting such investments. Issuers of securities in infrastructure-related businesses are subject to a variety of factors that may adversely affect their business or operations, including high interest costs in connection with capital construction programs, high leverage, costs associated with environmental or other regulations and the effects of economic slowdowns. Rising interest rates could lead to higher financing costs and reduced earnings for infrastructure companies. The Fund may invest in derivatives, which may increase the volatility of the Fund's NAV.

Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, 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 Taxable Municipal Index is a rules-based, market-value-weighted index engineered for the long-term taxable bond market.

Morningstar Ratings[4] as of 03/31/23

★★★ Class A

★★★★ Class I

Overall Morningstar Rating™ based on the risk-adjusted returns from among 414 Intermediate Core Bond funds.

		Stars	# of Funds
Class A	3 Yr	4	414
	5 Yr	4	378
	10 Yr	2	282
Class I	3 Yr	4	414
	5 Yr	4	378
	10 Yr	3	282

Top States (%)

California	19.2
New York	9.4
Texas	7.8
Washington	5.8
Massachusetts	4.6
New Jersey	3.5
Illinois	3.3
Pennsylvania	3.0
Virginia	2.4
Florida	2.4

Top Holdings (%)

Washington State, 5.09%, due 08/01/2033	2.0
Los Angeles Calif Cmnty College Dist, 7.53%, due 08/01/2029	1.9
Seattle Wash Municipal Lt & Pwr Rev, 5.47%, due 02/01/2030	1.5
Alabama Fed Aid Hwy Fin Auth Spl Oblig Rev, 1.727%, due 09/01/2028	1.4
Johns Hopkins University, 4.705%, due 07/01/2032	1.4

Portfolio data as of 03/31/23 Percentages based on total net assets and may change daily.

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