Adding resiliency to income portfolios with insured municipal bonds

INVESTMENT INSIGHTS

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Overview

Municipal bond insurance offers a range of benefits to investors, including default protection, guaranteed regular income, and enhanced liquidity. For these reasons, insured bonds can be particularly valuable in volatile investment climates like we are experiencing today.

The benefits of insured municipal bonds

Municipal bond insurance is a guarantee from a monoline insurance company (a company that focuses on just one type of insurance product) that the holder of a municipal bond will receive scheduled interest and principal payments when due, even in the event of a default by its issuer. In addition to default protection, bond insurance offers other significant benefits to investors. For instance, if a bond issuer is late in making interest and principal payments or halts payments for a period of time, the insurer will make those payments on the issuer’s behalf, ensuring the regular income stream that bondholders come to expect from their investment. Lastly – and perhaps most notably – bond insurance increases liquidity, which tends to be a bigger issue than defaults in the municipal bond market. Generally, insured bonds are more liquid than uninsured bonds. This is especially true the further down the credit spectrum you go.

Municipal bond insurance is often described as a “credit enhancement” as it enables a municipality to effectively borrow the credit rating of the insurer, which is typically higher than its own on the rating scale. This credit enhancement can help to reduce the borrowing costs of the issuer. For example, until the mid-2000s, most newly issued insured bonds were assigned a AAA credit rating, and as a result carried lower interest rates.

About MacKay Municipal Managers

MacKay Municipal Managers is a recognized leader in active municipal bond investing and is entrusted with more than $64 billion in assets, as of 12/31/20. The team manages a suite of highly rated, award-winning municipal bond solutions, available in multiple structures, including mutual funds and exchange traded funds.
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Municipal bond insurance can be traced back to 1971 with the founding of Ambac, the industry’s first monoline insurer. The value of insurance quickly became apparent in 1975, when New York City was in the throes of a fiscal crisis and a municipal default seemed imminent. The industry gained further traction in the mid-1980s after the Washington Public Power Supply System defaulted on $2.25 billion in revenue bonds.

Furthermore, market interest rates were high during the nascent days of monoline insurance, meaning that a credit enhancement generated attractive cost savings to issuers. By 2005, insured bonds made up 57% of total municipal bond issuance and were guaranteed by nine firms, seven of which carried AAA ratings. Today, monoline insurance companies are rated AA, a point that we’ll revisit shortly.

A look back: Perception vs. reality?

The fortunes of monoline insurers began to shift dramatically in the early- to mid-2000s, and as the financial crisis took hold in 2007-2008, most insurers either fell into bankruptcy or lost their AAA ratings. Contrary to popular misperceptions held at the time, municipal bond insurers got into trouble not because of their municipal bond holdings, but because they diversified into other risky asset classes, namely subprime mortgages.

Even today, there is a misconception that the insurers are primarily wrapping junk bonds. Taking a closer look at Assured Guaranty and Build America Mutual, the only two firms serving the municipal bond market, we find that both firms have little to no exposure to below investment grade bonds.

- **Assured Guaranty (AG):** only 3.1% of its U.S. public finance portfolio is rated below investment grade, with most holdings falling in the A-rated bucket, based on the firm’s proprietary internal rating scale, as of 9/30/20.
- **Build America Mutual (BAM):** 0% of its portfolio is below investment grade and is mostly A-rated, again based on their proprietary internal rating system, as of 9/30/20.

Further, S&P Global Ratings recently issued reports on AG and BAM, affirming strong credit ratings of AA for both firms. S&P wrote that, “BAM’s underwriting and risk-management guidelines result in an insured portfolio that does not reflect the overall U.S. municipal market and may perform better in a stressful economic scenario.”

With regards to AG, S&P noted that its underwriting and risk-management guidelines “result in an insured exposure that, in periods of economic stress, outperforms relative to the market segments in which they underwrite.”

Today, the market share of new municipal issues carrying insurance hovers around 7%, having dropped steeply following the credit crisis of 2008. Given past misconceptions about insurers and the size of the market today, it’s important for investors to partner with a trusted advisor/research team who can help understand what’s driving the market at any given time, do the necessary research, and evaluate individual insurance companies on their merits when choosing investments.


New municipal issues covered by insurance

![Chart showing new municipal issues covered by insurance from 2006 to 2020.](source: SIFMA, Bloomberg, as of 12/31/20.)
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Value in today’s world
This brings us to today’s extraordinary investment landscape and how insured municipal bonds are uniquely positioned to add value within this environment.

First, during times of stress or distress, there is typically a major gap between the performance of insured and uninsured bonds. A notable example includes Puerto Rican bonds, when the prices of insured bonds fell less than uninsured bonds during the distressed periods of the mid-2010s.

Second, timing is crucial. The cost of insurance is far less before a bond becomes distressed. For example, investors who owned insured munis before the start of 2020 are potentially in a strong position to reap benefits now that we are seeing stress on some state and local municipalities. While no one could have anticipated what was to come with the global pandemic, or the massive technical dislocation in the municipal bond market that resulted in the liquidity crisis in March, insured municipal bonds provided greater liquidity and weathered the storm. For example, insured Metropolitan Transportation Authority (MTA) bonds from New York City, the early epicenter of the COVID-19 outbreak, did not fall as much as uninsured bonds. Further, the MTA is still paying its bondholders, thus supporting the notion that insurance helps investors maintain a higher level of liquidity and mitigate market price pressure when a disruption is temporary.

For more information about insured municipal bonds and IQ MacKay Municipal Insured ETF (MMIN), which invests primarily in investment grade insured municipal bonds and is managed by the skilled credit specialists at MacKay Municipal Managers, visit www.muni360.com.
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Before considering an investment in the Fund, you should understand that you could lose money.

IQ MacKay Municipal Insured ETF (MMIN): The Fund may be susceptible to an increased risk of loss, including losses due to adverse events that affect the Fund’s investments more than the market as a whole, to the extent that the Fund’s investments are concentrated in the securities of a particular issuer or issuers, region, market, industry, group of industries, project types, group of project types, sector or asset class. 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. Fixed income securities most frequently trade in institutional round lot size transactions. Until the Fund grows significantly in size, the Fund expects to purchase a significant number of bonds in amounts less than the institutional round lot size, which are frequently referred to as “odd” lots. Odd lot size positions may have more price volatility than institutional round lot size positions. A portion of the Fund’s income may be subject to state and local taxes or the alternative minimum tax. 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, in which the bond issuer may fail to pay interest and principal in a timely manner. 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.

Insured Municipal Bonds are covered by insurance policies that guarantee the timely payment of principal and interest. The insurance does not guarantee the market price of an insured security, or the Fund’s share price or distributions, and shares of the Fund are not insured. The Fund may purchase insurance for an uninsured bond directly from a qualified Municipal Bond insurer. The supply of insured municipal securities which meet the Fund’s investment guidelines is limited.

Consider the Fund’s investment objectives, risks, and charges and expenses carefully before investing. The prospectus and the statement of additional information include this and other relevant information about the Fund and are available by visiting www.newyorklifeinvestment.com or calling 888-474-7725. Read the prospectus carefully before investing.

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