Opportunities in active municipal bond fund management

Author | **Jon Dowiak, CFA**
Sponsor | **New York Life Investments and MacKay Municipal Managers™**

As interest rates rose through 2022-2023, many municipal bond investors sought to take losses on existing investments and quickly implemented new positions. For many, this involved rotating into basic strategies such as separately managed account (SMA) ladders or passive index ETFs. While these approaches may have been adequate during a period when relative value analysis was often overwhelmed by interest-rate volatility, we believe today's conditions make the case for actively managed municipal funds.

For prudent active managers, the rising rate environment has allowed mutual funds to book attractive yields in portfolios, raise dividend distributions and harvest losses to manage against future capital gains — the benefits of which are now being felt as rate volatility subsides and markets normalize. Reduced interest-rate volatility potentially offers room for greater contributions from active relative value decisions, including yield curve positioning and credit analysis. As rates stabilize or fall from here, we believe actively managed funds can benefit from having locked in the higher yields previously available in the market.

In the remainder of this commentary, we will discuss the current municipal market dynamics that support our view toward actively managed funds being well positioned to drive excess return potential.

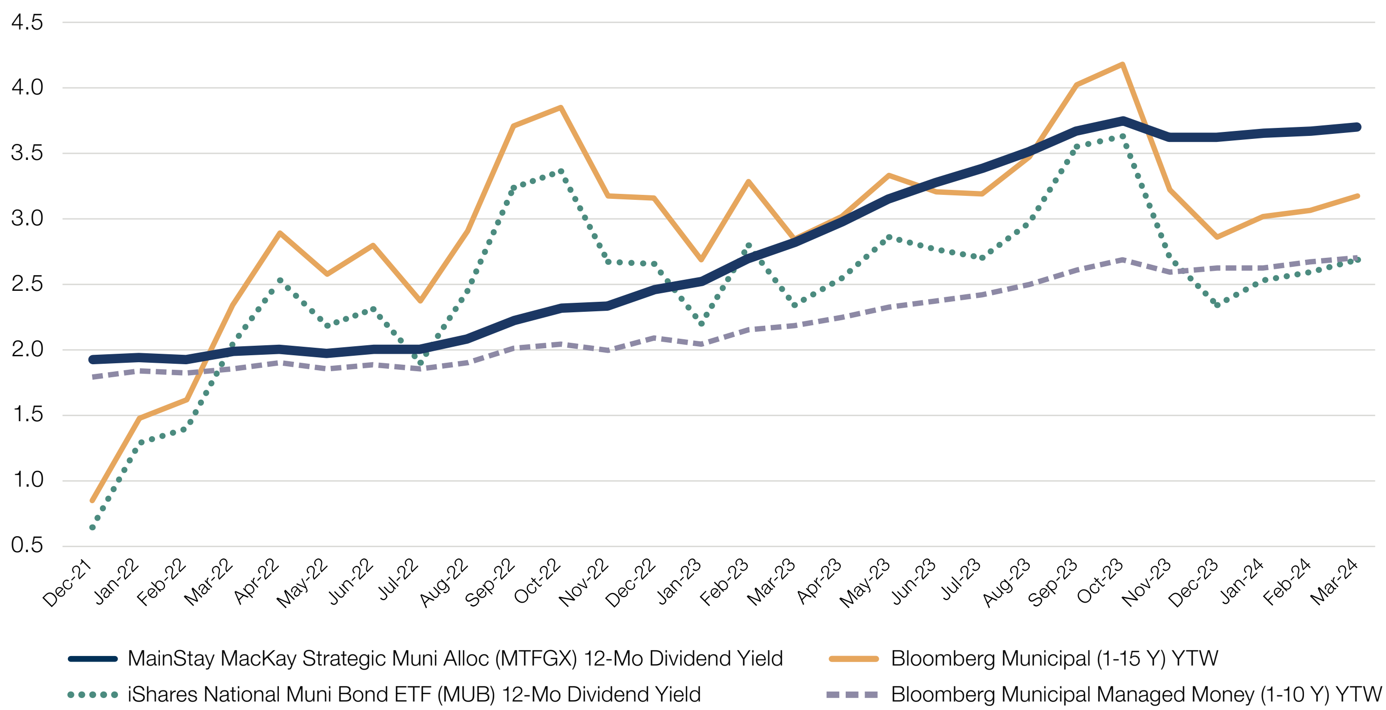
Identifying your municipal strategy's yield potential

It is important to understand how yields are accounted for in various municipal investment approaches. The yield on a new SMA portfolio will be based on the bond yields currently available in the market at the time of its formation. By contrast, commingled municipal bond mutual funds can "book" the yields of newly added bonds and preserve this book yield over the term period. All else equal, booking higher yields can potentially increase fund dividend distributions and maintains the higher income generation as market rates fluctuate.

Active mutual funds that were able to book higher yields for portfolios in recent years may now offer higher tax-exempt dividend yields than what is currently available in the market through individual bonds or SMAs. **Figure 1** diagrams how the **MainStay MacKay Strategic Municipal Allocation Fund** dividend yield has risen as new bonds were added to the portfolio, and now sits above the Fund's benchmark yield to worst (YTW) and the Bloomberg Municipal Managed Money 1-10 Year Index YTW. The Fund also has a higher dividend yield than the largest passive index ETF[1], which did not benefit from actively repositioning into higher-yielding positions.

Actively repositioning portfolios into higher-yielding bonds via tax-loss swaps is also tax efficient, as it harvests the tax losses from depreciated bonds and converts tax-inefficient price recovery into higher tax-exempt income streams.

Figure 1. MTFGX dividend yield is now higher than market index rates[2]



Source: Bloomberg as of 3/29/2024. The Bloomberg Municipal (1-15Y) YTW is the lowest expected yield that investors can get from municipal bonds with maturities between 1 and 15 years. The Bloomberg Municipal Managed Money (1-10Y) YTW is the lowest expected yield from municipal bonds with maturities of 1 to 10 years. The **iShares National Muni Bond ETF** (MUB) 12-Mo Dividend Yield is the percentage representing the annualized dividend payout of the MUB ETF over the past year, relative to its current share price. The **MainStay MacKay Strategic Municipal Allocation Fund** (MTFGX) 12-Mo Dividend Yield is the percentage representing the annualized dividend payout of the MTFGX mutual fund over the past year relative to its current share price. It is not possible to invest directly in an index. Past performance is not indicative of future results. **Click on the fund name for the most current fund page, which includes, the prospectus, investment objectives, performance, risk, Morningstar ratings and other important information. 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 nylinvestments.com/funds and for the most recent month-end performance.**

The municipal yield curve offers relative value opportunity

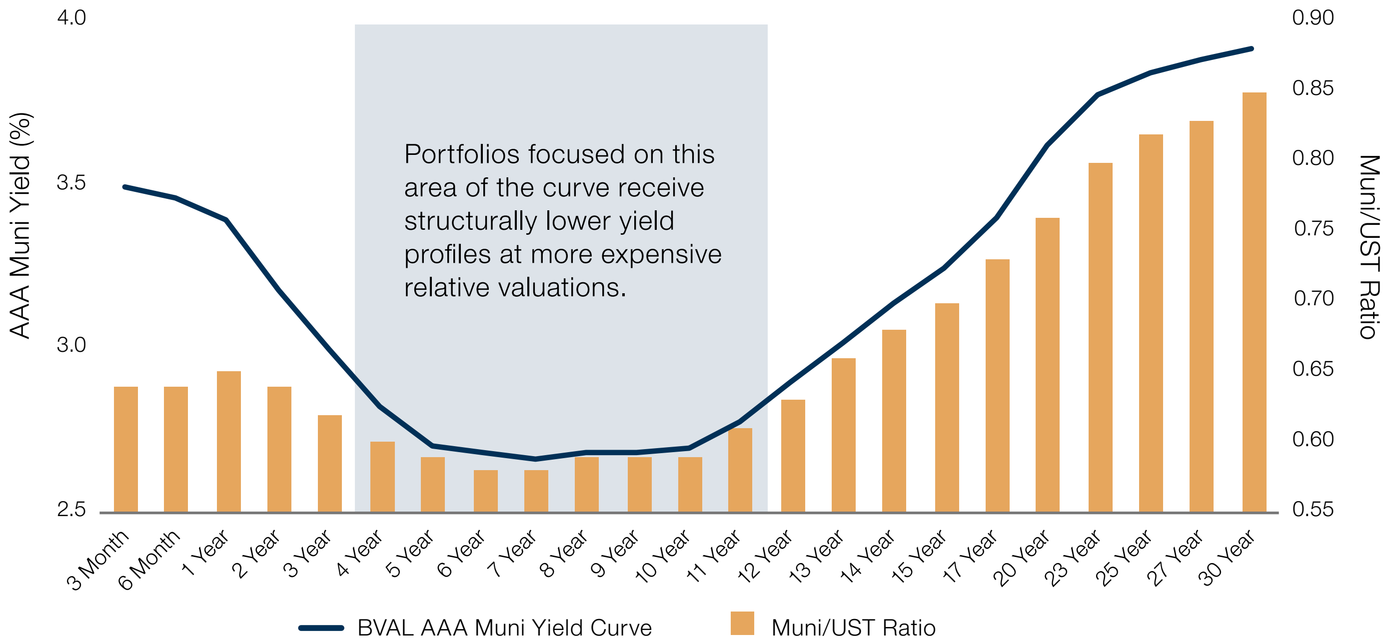
High inflation and U.S. Federal Reserve (Fed) tightening contributed to a period of rapidly rising interest rates during 2022 and 2023, leading to rate volatility that dominated other components of fixed-income analysis. As rates stabilize and the Fed seeks to end its rate hiking activity, market conditions in our view are again supportive of active relative value bond management.

The Fed's aggressive rate increases have produced a sustained Treasury yield curve inversion, eventually contributing to an unusually shaped municipal yield curve as well. Unlike Treasuries, the municipal market has developed a "U"-shaped yield curve — inverted in the short-intermediate tenors and steeper in the intermediate-long (**Figure 2**). This means higher yields and better relative valuations at the long end of the curve, and lower income potential and poorer relative valuations in the midsection.

Across strategies, MacKay Municipal Managers' actively managed portfolios are able to overweight toward attractive yield curve segments, seeking excess return potential as the curve normalizes. By contrast, other municipal approaches, such as intermediate-maturity SMA ladders, may be restricted to investing more in relatively expensive maturities.[3]

Figure 2. Ultra high-grade bonds in the midsection of the curve have offered lower income and poorer relative value

AAA municipal yield curve and municipal-to-Treasury yield ratios



Source: Bloomberg as of 4/10/2024. The Muni/UST ratio refers to the ratio between the yields of municipal bonds (muni) and U.S. Treasury securities (UST). The BVAL AAA Muni Yield Curve, provided by Bloomberg, is a set of yield data points representing the yields of AAA-rated municipal bonds across various maturities.

Municipal market conditions support a relative value approach

Beyond the strategies referenced above, we believe many opportunities exist for active municipal management in the current environment. Should interest rates decline, deep credit research becomes more necessary to source compelling yields beyond the most liquid, high-grade issues. If monetary tightening effects challenge the economy or specific municipal sectors, active management can take advantage of attractive spread opportunities through relative value analysis. Lower interest-rate volatility may benefit price discovery, rewarding opportunistic security selection.

With attractive tax-exempt dividend yields and an active relative value approach, we believe our suite of MacKay Municipal Managers funds are well equipped for success in this market compared to other municipal approaches with more restrictive or passive mandates.

1. The largest muni ETF is the iShares National Muni Bond ETF (MUB) with $36.9B in assets as of 3/31/24. Source: **iShares National Muni Bond ETF (MUB)**

2. MainStay MacKay Strategic Municipal Allocation Fund's dividend yield increased with new bond additions, surpassing its benchmark, Bloomberg Municipal Managed Money 1-10 Year Index and iShares National Muni Bond ETF (MUB).

3. Bonds in the midsection of the curve offered lower income and poorer relative value. Thus, intermediate-maturity SMA ladders may be restricted to investing more in relatively expensive maturities.

DEFINITIONS:

Yield to Worst is an estimate of the lowest yield that you can expect to earn from a bond when holding to maturity, absent a default. It is a measure that is used in place of yield to maturity with callable bonds. As callable bonds can be bought back before their stated maturity date, yield to maturity does not provide an accurate picture of what an investor can expect to earn.

The **Bloomberg Municipal Managed Money 1-10 Year Index** is an index that tracks the performance of separately managed accounts (SMAs) invested in short- to intermediate-term municipal bonds, typically with maturities ranging from 1 to 10 years. This index provides a benchmark for the performance of actively managed municipal bond portfolios within this duration range.

The **Bloomberg Municipal Bond 1-15 Year Index**, part of the broader Bloomberg Municipal Bond Index, focuses on USD-denominated long-term tax-exempt bonds in the 1–15-year range, covering sectors like general obligation, revenue, insured, and prerefunded bonds. It serves as a benchmark for investors, assuming reinvestment of all capital gains and dividends.

ABOUT RISK:

Before considering an investment in the Fund, you should understand that you could lose money.

MainStay MacKay Strategic Municipal Allocation Bond Fund: A portion of the Fund's income may be subject to state and local taxes or the alternative minimum tax. Income from municipal bonds held by the Fund could be declared taxable because of unfavorable changes in tax law, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. High-yield municipal bonds may be subject to increased liquidity risk as compared to other high-yield debt securities. The Fund may invest in derivatives, which may increase the volatility of the Fund's NAV.

IMPORTANT DISCLOSURES

Past performance is not a guarantee of future results. Active management typically involves higher fees than passive management.

This content reflects the opinions of its authors, but not necessarily those of New York Life Investments or its affiliates. It is distributed for informational purposes only and does not constitute advice or a recommendation to purchase any product. The expressed opinions are subject to change without notice. The investment strategies discussed may not be suitable for every investor and do not consider individual financial needs. The material provides an assessment of the market environment as of a specific date, but it is not a forecast of future events or guaranteed results. It is not intended as research or investment advice for specific funds or securities.

MATERIAL DIFFERENCES BETWEEN MUTUAL FUNDS (MF), AND SEPARATELY MANAGED ACCOUNTS (SMA):

Security selection MF investors cannot dictate which securities will be in the fund. SMA investors can request the manager sell an individual security or restrict exposure to certain securities. Liquidity: MFs offer daily liquidity, although there may be transaction fees involved. With SMAs, it may take a few days to get your money fully invested and managers may only allow the liquidation of managed accounts at certain times. Capital gains: MFs must pay out income and capital gains to investors, which is a taxable event. With SMAs, an investor can ask a manager to be as tax-efficient as possible and to try to offset gains and losses. Account minimums and costs: MFs typically have lower minimum accounts sizes than SMAs. MFs may also carry sales charges. SMAs typically charge higher fees than MFs due to their customizable nature. Holdings: SMA investors may request access to account holdings at any time. MFs report holdings periodically on a set schedule.

For more information
800-624-6782
newyorklifeinvestments.com

6547270 MS091-24

MS81m-04/24