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Better at a discount

Now in progress is a bullish sequel to the municipal-bond analysis in the July 27 issue of *Grant's*. We were guardedly bullish two weeks ago. As munis were yielding just 83% of the comparable Treasury rate, there was no call for euphoria. The tone of the piece was one of resignation: If you need income, you take the best, or least worst, of what Mr. Market has to offer.

Closed-end tax-exempt funds, quoted at discounts to NAV, offer better yields, with the proviso that a seemingly deep discount can always deepen. On tap is a sampler of five representative funds.

The creditworthiness of the debtor states and localities is just where we left it a fortnight ago. On the one hand, the long economic expansion has made no constructive mark on the funded status of the public pension funds. Showing a cumulative actuarial deficit of $1.4 trillion, it rather prompts the question, "What will the next recession bring?" (see page 1).

On the other hand, among recent Moody's and S&P general-obligation ratings actions are these: Minnesota raised to triple-A from double-A-plus; Michigan raised to double-A from double-A-minus; Illinois's outlook upgraded to stable from negative; California's outlook upgraded to positive from stable.

"Perhaps," colleague Fabiano Santin reflects, "this is just another example of late-cycle optimism. But maybe the U.S. Supreme Court decisions this July to allow the taxation of online sales and to free government workers from union dues will help keep budget and pension liabilities under control."

The largest state- and local-government tax categories (income, property, sales and "other") rose to $350.2 billion in the first quarter, up 5.8% from a year ago. Such signs of fiscal prosperity are a mixed blessing for municipal bondholders. The influx of tax dollars into state coffers tends to correspond with rising interest rates. Rising interest rates, in turn, tend to correspond with worried investors hitting the "sell" button on their closed-end muni funds.

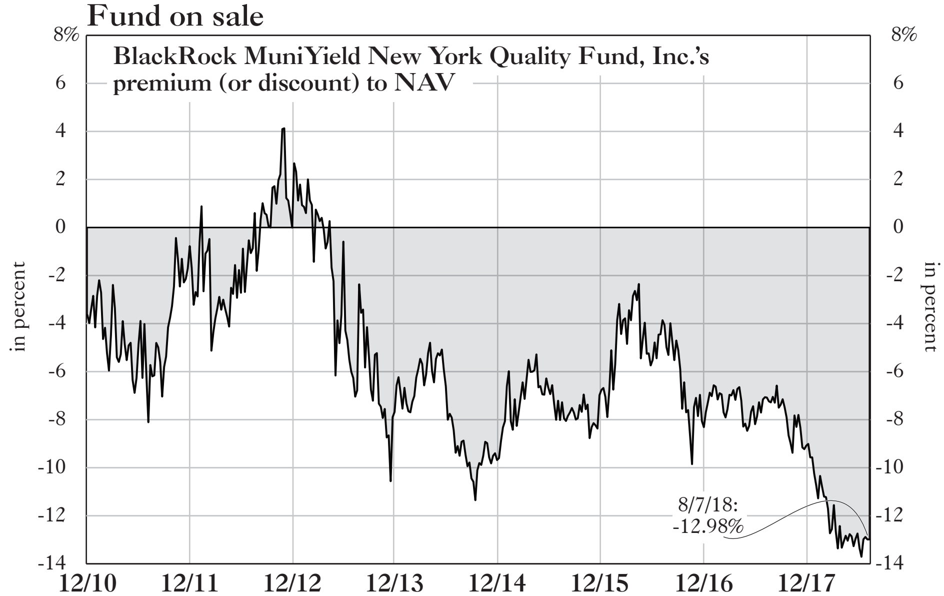
"We've been on-and-off involved in this trade since 2013 when we had the taper tantrum," Chris Pavese, paid-up subscriber and chief investment officer at Broyhill Asset Management, tells Santin. Now it's on again, as the funds are trading at double-digit discounts for the first time since the 2008 crisis.

"Prior to that," Pavese goes on, "a lot of these funds and many yield-oriented vehicles were trading at a premium because people were starved for yield and rates were stuck at zero." Then, as rates unstuck, the prices of the underlying bonds declined, the closed-end NAVs declined and retail holders unloaded. A cyclical evergreen.

After the taper tantrum, the closed-end funds began the climb back to par. With the sell-off in bonds that followed the 2016 presidential election, the climbing ended and the descent began to the deep discounts you find today.

The tax-exempt yields you'll be reading about do not occur in nature but rather are enhanced through leverage. The funds typically employ debt equivalent to about 0.6 to 0.7 times equity—

Fund on sale



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they are permitted to issue an amount of preferred shares up to the amount of their equity. Leverage makes their net asset value more volatile.

For New York-based clients in the top tax bracket, Pavese holds shares of BlackRock MuniYield New York Quality Fund (MYN at the Big Board). The fund manages a $903 million portfolio, whose net asset value becomes $543 million after subtracting leverage. It changes hands at a 13% discount and has traded at an average discount of 5.7% since 2010—the largest discount was 13.8% in July.

The fund holds 72% of its assets in triple-A- and double-A-rated securities, less than 7% in triple-B-rated paper—and less than 1.5% in speculative-grade and non-rated bonds. The fund's effective duration is 9.5 years and its current yield, based on the dividend distribution, is 4.2%, or 7.1% in tax-equivalent yield from Treasurys. Its expense ratio is 0.89%.

A lower-duration fund for residents of Gov. Andrew Cuomo's (and Mayor Bill de Blasio's) tax paradise is the Eaton Vance New York Municipal Bond Fund (ENX on the New York Stock Exchange) with credit quality similar to MYN. Total assets foot $349 million with leverage making up 41% of that sum. The fund trades at a 14% discount, more than twice the averaged 6.7% discount since 2010. It has an effective duration of 6.8 years. Its dividend yield is 4.8%, or 8.2% on a tax-equivalent basis to Treasurys. Its expense ratio is 1.2%.

The happy residents of states that levy no income tax may consider the broader Invesco Value Municipal Income Trust (IIM on the Nasdaq). It manages $1.2 billion and trades at a 10% discount, more than double the average 4.3% since 2010. Its effective duration is 10.9 years. Its dividend yield is 5.3%, or 8.9% on a tax-equivalent basis to Treasurys. Its expense ratio is 0.86%. Single-A- or better-rated securities make up 73% of the portfolio. Exposure to triple-B munis is 14% with 6% in junk and 7% in non-rated securities.

"There is one North Carolina Nuveen fund that we own a lot of and that trades at a nearly 15% discount to NAV today [compared with an average discount of 7.1% since 2010]," says Pavese, whose business hangs its hat in Lenoir, N.C. "North Carolina is a relatively high-tax state, and it's a relatively good local credit. Owning this thing at a 15% discount, yielding 5% tax-free, that's a no-brainer to us."

Pavese is talking about the $400 million Nuuveen North Carolina Quality Municipal Income Fund (NNC on the Big Board), which uses leverage equivalent to 40% of assets. The portfolio leans towards the higher end of the credit spectrum, with 76% allocated to triple-A and double-A issuers, 15% to single-As and 7.5% to triple-Bs. The fund yields 3.8%, or 6.4% on a tax-equivalent basis. The portfolio has a duration of 11.1 years, and the expense ratio is 2.35%.

Our final entrant is the $788 million BlackRock MuniYield Quality Fund (MQY on the NYSE). Vital signs include: 38% leverage, a 4.8% dividend yield (equivalent to 8.2% on Treasurys), 10.7 years duration and a 2% expense ratio. The fund is 59% exposed to triple-A and double-A munis, 27% to single-A bonds, 10% to triple-Bs, 4% to double-Bs.

"It trades at a 9.6% discount to NAV," Santin reports, "a level that doesn't seem to last long, based on a decade's worth of trading experience. Thus, an 8% discount in November 2016 morphed into a premium within six months."

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