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Political risk in America

Even if Alexandria Ocasio-Cortez winds up losing the 2020 presidential election, one tax-related shock is unavoidable. In two short months—the precise date is April 15—blue-state, upper-income federal-tax filers will be reminded of just how much they miss the state and local deductions that vanished with the 2017 Tax Cut and Jobs Act.

Tax-exempt income, along with its attendant rewards and risks, is the topic of the essay in progress. A canvass of bad actors, underfunded pension plans and unimaginative algorithms is the first order of business. An updated survey of opportunities in closed-end tax-exempt funds is the second. In preview, those deeply discounted funds offer a margin of safety in a bond market not exactly overflowing with bargains. To be clear, such investments likewise come complete with credit risk and leverage.

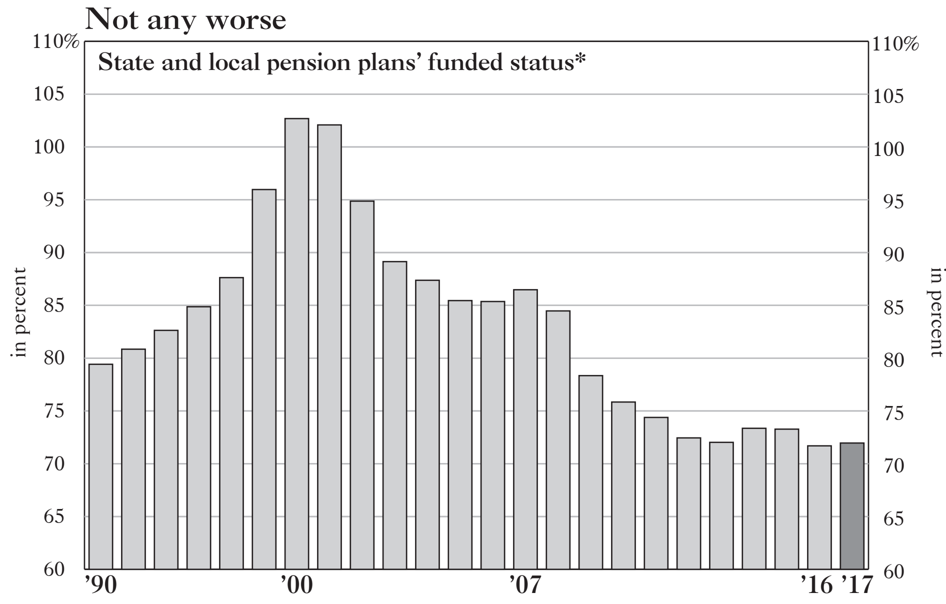
The tax-exempt world is a world unto itself—the bonds within it, as the investor Paul J. Isaac has memorably remarked, "are particular and specific to a remarkable degree." We count four distinguishing features.

No. 1, there are 50,000 issuers and 1 million securities outstanding. Compare and contrast the 10,000 issuers and 30,000 securities in the worldwide corporate-debt market. Feature No. 2 is the market's sterling 0.18% average investment-grade default rate recorded between 1970 and 2016. It's a speck compared with the 1.74% default rate registered for American investment-grade corporate borrowers over the same interval.

A third distinguishing characteristic is extreme illiquidity. Only a tiny percentage of those million issues trade on a given day. It's this illiquidity, according to Patrick Luby, senior municipal strategist at CreditSights, that explains the unusual steepness of the muni yield curve, which is tax-exempt watermark No. 4. It's easy enough to buy bonds in the new-issue market, but hard to sell them in the secondary market. Relatively high long-dated yields compensate the buyers of newly issued securities for the disappointment they will probably face when the time comes to sell.

We'll pass quickly over the dangers inherent in the underfunded pension plans of a majority of the 50 states and thousands of municipalities. It's not that the risks aren't palpable, only that they've become familiar. Thus, according to the excellent Center for Retirement Research at Boston College, the aggregate funded ratio (i.e., assets to liabilities) of state and local pension plans under conventional public-sector accounting rules was 72% in 2017, little changed from the preceding several years. It was near the peak of the tech bubble in 2000 that the states and localities achieved a funded status of 102.7%—how secure and well-managed they must have seemed at that phantasmagoric moment.

Perhaps a more informative way of looking at the public-pension problem is to observe that the aggregate funding status has been in decline for almost 20 years and that the average figure masks huge disparities among the states.



* The 2017 funded ratio involves projections for 18% of PPD plans, representing 26% of liabilities.
sources: 2017 actuarial valuations; Public Plans Data, 2001–17; and Zorn, 1990–2000, Center for Retirement Research at Boston College

Thus, in 2017, the top third of the plans was 90% funded, the middle third 73% funded and the bottom third 55% funded. Illinois, Connecticut, Kentucky and New Jersey are among the worst of the bottom dwellers.

It can't be said that the market is panicking over pension risk. For instance, Illinois, whose pension-funding deficit reached $250 billion in 2017 as Moody's does the counting, retains a borderline investment-grade bond rating of Baa3/triple-B-minus. Its 30-year general-obligation bonds are quoted at 4.8%, a 170 basis-point premium to the average 30-year, triple-A-rated tax-exempt yield. It's ample compensation for the risk, Paul Malloy, head of municipals at Vanguard, tells Bloomberg. Still less stressed is Aa3/single-A-rated Kentucky, another pension underachiever (its shortfall is $48 billion, says Moody's), which hasn't issued GO debt since 1966 but whose 30-year "certificates of participation" are priced to yield 3.5%, 40 basis points over the triple-A GO average.

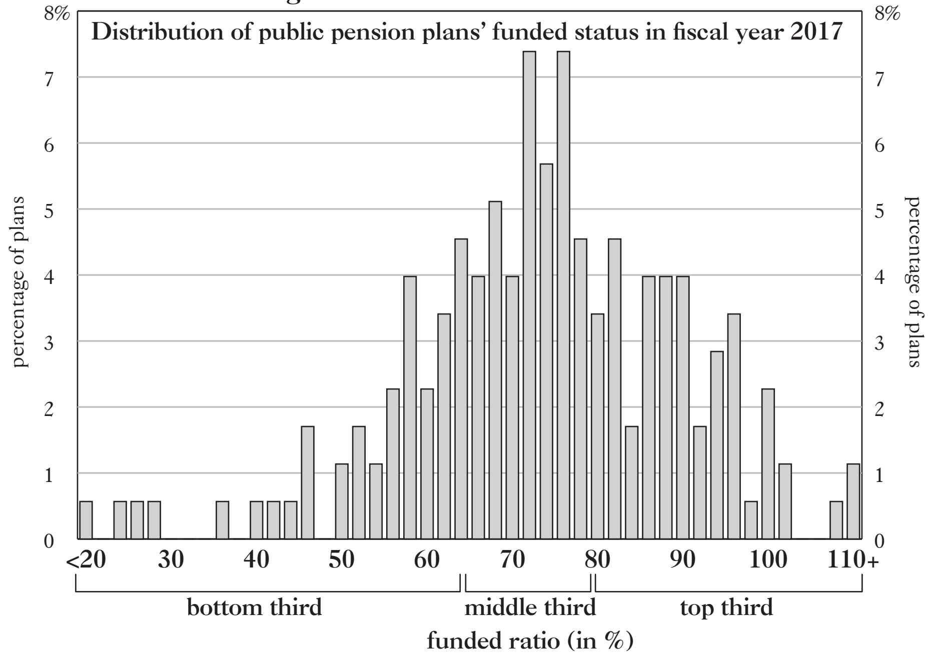
Last month brought the third annual Financial State of the Cities report by the promisingly named, politically unaffiliated, non-profit organization Truth in Accounting. Analyses of the finances of America's 75 most populous cities show that unfunded liabilities from pension and other post-employment benefits (a.k.a. OPEB, or healthcare liabilities) reached $330 billion as of June 30, 2017.

"Although the average pension-funded ratio for the 75 cities stands at a seemingly manageable 69%," colleague Fabiano Santin relates, "only 12% of future OPEB liabilities were funded—accounting rules require governments to start disclosing those figures on their balance sheets for the fiscal year ended June 30, 2018. OPEB is the source of a sizeable portion of those unfunded liabilities; they stood at $139 billion in mid-2017."

Bill de Blasio's New York City, which owes $64,100 per taxpayer in unfunded healthcare liabilities, earns a grade of "F" from the Truth in Accounting authors. They crown it the worst such offender among the cities—the runner-up bad actor, Chicago, owing a mere $36,000 per taxpayer.

The ratings agencies take a different, or perhaps more comprehensive, approach to urban credit quality, appraising New York Aa2/double-A. Mr. Market, too, dissents from the evident pricing implications of the letter grade F, with the New York 3½s of 2046 priced to yield 3.63% vs. the 5.1% assigned to the Chicago 5½s due 2042.

What the average obscures



source: Public Plans Data, 2017, Center for Retirement Research at Boston College

Or perhaps illiquidity is the greater peril. Long before a state availed itself of the bankruptcy laws, says the previously quoted Luby, it would lose its investment-grade rating. Its bonds, rendered ineligible for investment by funds prohibited from holding junk, would fall heavily onto a reluctant market. So-called auto bidders and algorithmic bidders would deepen the distress, since, for a certain number of these machines, the decision to invest or not invest is binary. "They'll just turn off the CUSIP [i.e., the security's ID number], they'll turn off the issuer," Luby says. "So a holder who's trying to sell may see the number of bidders on a block [of bonds] go from 20 to three or four."

All this sounds grim enough. A bull might object that the real story lies in the facts collected in the National Association of State Budget Officers's fall 2018 fiscal survey, to wit: 40 states topped their original revenue projections for the 2018 fiscal year, highest in a decade; state general-fund revenues grew 6.4% in 2018, fastest since 2013; and the states' rainy-day funds have reached a median of 6.4% of general-fund spending in 2018, better than the 4.8% seen in June 30, 2007.

Anyway, there are risks, there are rewards—and there are discounted, leveraged closed-end funds (see the analysis in the issue of *Grant's* dated Oct. 19, 2018). The funds generate incremental return by borrowing short and lending long, a stratagem that has landed many a bank in hot water. At least, in comparison to the typical bank, the funds are moderately leveraged. As a rule, borrowings represent roughly 40% of assets. They take the shape of short-term debt priced off a standard seven-day municipal money-market rate, the mouthful known as the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap index. Its movements closely parallel those of the federal funds rate.

The bigger the gap between bond yields and SIFMA, the better it is for the investor; and, of course, vice versa. At the start of the previous rate-hiking cycle in early 2004, the BlackRock MuniYield New York Quality Fund (MYN on NYSE Arca) paid a monthly dividend of 7 cents per share. By late 2006, as the funds rate climbed to 5% from 1%, and SIFMA to 4% from 1%, the payout had tumbled by 23%, to 5.4 cents a share.

Chairman Jay Powell's recent rethink of the timeline to interest-rate normalization has brought a sigh of relief to leveraged muni-fund investors. On Nov. 15, 2018, perhaps anticipating the Fed's about-face, BlackRock Advisors, LLC authorized the boards of their various closed-end muni funds to repurchase up to 5% of their shares outstanding.

The New York-based funds featured

Closed-end municipal funds at a glance, Feb. 4, 2019

	managed assets (in millions)	latest premium (discount)	dividend yield	tax-equivalent yield*	dividend coverage**	three-month unrealized net investment income**
BlackRock MuniYield New York Quality Fund (MYN)	$787.5	-12.7%	4.3%	7.2%	104%	$0.03
BlackRock MuniYield Michigan Quality Fund (MIY)	674.1	-14.1	4.9	8.2	100	0.03
BlackRock MuniYield Pennsylvania Quality Fund (MPA)	341.2	-12.8	4.8	8.2	102	0.00
BlackRock MuniHoldings New York Quality Fund (MHN)	686.2	-12.7	4.3	7.3	105	0.01
BlackRock California Municipal Income Trust (BFZ)	791.9	-12.9	4.3	7.2	103	0.00
Eaton Vance New York Municipal Bond Fund (ENX)	377.0	-11.9	4.4	7.4	89	0.01
Nuveen North Carolina Quality Municipal Income Fund (NNC)	376.0	-14.7	3.5	6.0	111	-0.03
BlackRock MuniYield Quality Fund (MQY)	778.3	-9.2	4.9	8.3	102	0.03
Nuveen New York Quality Municipal Income Fund (NAN)	684.5	-11.9	4.5	7.6	100	-0.02
BlackRock Investment Quality Municipal Trust (BKN)	437.2	-9.0	4.9	8.3	104	0.07

no longer attractive

*Assumes 40.8% federal tax rate. **As of Dec. 31, 2018.

source: The Bloomberg

in these pages (MYN, NAN and ENX) trade with discounts of around 12% of NAV. NAN is hereby stricken from the favorites list on account of its 10% exposure to high-yield paper. BlackRock MuniHoldings New York Quality Fund (MHN on the Big Board) takes its place.

MHN shows $686 million in total assets, of which 40% are financed with borrowed money. Effective duration is 10.2 years, meaning that the portfolio is long-dated. Ninety percent of that portfolio comprises bonds rated single-A to triple-A; triple-B-rated securities account for the rest. The fund trades at a 12.7% discount, and its dividend yield is 4.3%, or 7.3% on a tax-equivalent basis to Treasurys. The expense ratio is 2.4%.

The happy residents of Washington, Texas, Florida, Alaska, South Dakota, Wyoming and Nevada, who pay no state income taxes, have no need to invest in their enlightened home states. A pair of national, or non-state-specific, funds, MQY and BKN, change hands at around 9% discounts, but there's a cheaper alternative in the BlackRock MuniYield Michigan Quality Fund (MIY, also on the Big Board).

The Michigan fund shows $674 million in total assets, of which 39% are financed with borrowed money. Ninety-seven percent of the portfolio comprises single-A- to triple-A-rated securities, with triple-B-rated bonds furnishing the remainder. The fund's duration is 10.8 years. It trades at a 14.1% discount, and its dividend yield is 4.9%, or 8.2% on a tax-equivalent basis to Treasurys. The expense ratio is 2.2%.

Double-A-minus-rated Pennsylvania furnishes the portfolio contents of the BlackRock MuniYield Pennsylvania Quality Fund (MPA). Leveraged by 40%, MPA holds $341 million in total assets, of which 11% are rated triple-B and the balance single-A and higher. Duration is 11 years, discount to NAV is 12.8% and the dividend yield is 4.8%, or 8.2% on a tax-equivalent basis to Treasurys. The expense ratio is 2.3%.

There are four possible sources of distribution from closed-end funds: interest income, dividends, realized capital gains and return of capital; since the last one diminishes management fees to the sponsor, it's a much less common one. Please cast your eye on the column headed "dividend coverage" in the accompanying table. Measuring a fund's interest income as a percentage of the dividends it pays, it's a handy indicator of the sustainability of the current dividend payout rate.

Then there's "unrealized net investment income," which measures the cushion available to protect a fund's earnings shortfall from crimping distributions. We overlooked it in our Oct. 19 survey but highlight it now. Newly alert, we strike a pair of Nuveen funds from our preferred list: NNC and ENX. In neither case is there enough UNII to protect against a distribution cut if earnings drop. There are more attractive opportunities on the wing.

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