Rareview's Azous: Muni Bonds Represent Unique Opportunity Now

Thursday, July 2, 2020

Chuck Jaffe, in The NAVigator podcast, interviewed Neil Azous, chief investment officer at Rareview Capital in Stamford, Connecticut. Read the Q & A below as Neil discusses how the four ways that investors typically make money in municipal-bond closed-end funds typically aren't all in favor at the same time. These times however, are anything but typical, and Azous says that in the current unusual times, all four potential return streams are lining up in ways that make muni funds a particularly attractive option right now.

Neil Azous

The podcast can be found on AICA's website by clicking here: https://aicalliance.org/alliance-content/pod-cast/

CHUCK JAFFE: Neil Azous, chief investment officer at Rareview Capital is here, and we're talking about the challenges of investing in closed-end funds, particularly muni bond closed-end funds, right now on The NAVigator. Welcome to The NAVigator, where we talk about all-weather active investing and plotting a course to financial success with the help of closed-end funds. The NAVigator's brought to you by the Active Investment Company Alliance, a unique industry organization that represents all facets of the closed-end fund industry, from users and investors to fund sponsors, and creators, and investors. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today we're going to point you in the right direction of Neil Azous, he's chief investment officer at Rareview Capital, which is a firm that basically uses closed-end funds to achieve its income goals. And if you want to learn more, check out RareviewCapital.com. And by the way, Neil's on Twitter, he is @NeilAzous. If you want to learn more about closed-end fund investing, make sure you check out the website for the Active Investment Company Alliance, it is AICAlliance.org. Neil Azous, thanks for joining me on The NAVigator.

NEIL AZOUS: Thanks Chuck, I appreciate you having me today.

CHUCK JAFFE: Neil, closed-end funds have been in a particularly interesting space throughout this pandemic. Discounts expanding than narrowing, and a lot of wild movement and people seeing distributions cut and more. So let's start there. Have closed-end funds taken it on the chin more than other types of assets? Has it been harder to navigate these markets using closed-end funds?

NEIL AZOUS: The short answer is, yes, it can be more difficult, especially when there's a significant amount of dislocation in the market as you just described. But the opposite also happens to be true, that dislocation creates opportunity, and not all closed-end funds are treated equally. There are significant differences between one asset class or another, or the absolute level of one discount versus another. And the opportunity set can be very vast depending on what you're interested in at the time. If you know what to do and where to look, you can take advantage of that fear that's in the marketplace, and that's what makes closed-end funds distinct from other products.

CHUCK JAFFE: So what you're saying is some babies got thrown out with the bathwater here. That you could be looking at the same asset class, everybody got tarred with a broad brush. What that really means is that there's a buying opportunity underneath it for some?

NEIL AZOUS: That's right. So in the case of one sector say versus anther, there are still asset classes or sectors that are trading at a larger discount than one would expect given the government support that has come in. So for example, the credit sector has seen a significant repair process as result of some of the government initiatives. Whereas say, the municipal-bond sector is still waiting to have that same steepness in the degree of recovery that say the credit sector has. So if you know where to look and you understand where things were and where they should be based on certain valuation metrics that some people deploy, there is an opportunity. But you have to have a background in them, and you have to be able to see the distinction between the two. I wouldn't say that all asset classes are ripe for a buying opportunity, there are some that can have an ongoing dislocation. For example, commercial real estate might be impaired for the next six months or almost on an indefinite basis until we understand what the work from home situation truly ends up being. Whereas there might be an overstatement of concern related to the credit quality of municipal issuers during this period, and that might be considered a buying opportunity.

CHUCK JAFFE: One of the interesting areas, and it's a huge area both for you as an investor, but also as it's the largest chunk of the closed-end fund space, is muni bonds. Muni bonds have a few different issues that I'm wondering how you see them playing out. Obviously we've got interest rates lower for longer, but we also have municipal issuers where they normally get the bulk of their revenue from tourism and things along those lines. And no tourism means these bond issues, maybe we're going to see some impairments and defaults down the line. How do you think the muni bond story's going to play out particularly as it applies to muni bond closed-end funds.

NEIL AZOUS: That's a very fair question just given the gravity of the pandemic and what it's inflicted on different municipalities. I'll give you an alternative way to think about that sector, and not necessarily think about it through the lens of the underlying cash municipal-bond market. Because closed-end funds and the wrapper of closed-end funds are a different animal or a different investment vehicle than the underlying bonds along the way. Just to give everyone a yardstick, the municipal-bond closed-end fund sector makes up about 1/3 of all of closed-end funds. So it is the largest and the most liquid, and we find that discounts to net asset values tend to move around the most on an intermediate term basis. Meaning there's the most movement up and down throughout the intermediate term.

When you think about municipal closed-end funds, you want to think about them in four different ways. You certainly have the net asset value and whether the underlying bonds can go up or down. You have the high-income distribution yield that they spit out. You have the potential for the entire sector to see discount to net asset value tightening. And if you know what you're doing or you're a specialist in the space, you could potentially take advantage of some of the changeovers in those discounts. And the reason that this is a distinct opportunity at the moment, is that periodically there's an opportunity to harvest really just two or three of those return streams at the same time. Historically though, it's extraordinarily rare that all are aligned simultaneously like they are right now, especially to this degree. So for example, in the cash bond market that you're talking about, there's no question that there's going to be ongoing headline risk going forward. That's just a rational and logical observation that we will have to live with that based on these revenues deteriorating because the pandemic.

However, when it comes to a closed-end fund they are broadly diversified. They tend to have anywhere between say 800 and 1,200 individual securities or issuers. They are broken up at the state level, where there isn't too much of one state versus another. They're also broken up at the sector level, where there's a clear distinction between a hospital bond or general obligation bond or university bond for example. And so when you look at the actual underlying bond story at the moment, there is absolutely scope for net asset value appreciation. And you have to recognize that similar to other asset classes, the government programs that were enacted, have effectively at this moment cut off the left tail risk of municipalities not being able to access the capital markets for new issuance. So when you actually look at the performance of the underlying securities at the moment, most people would be surprised that the broad municipal index at the moment is actually up around 2% on the year. And if you go all the way down to a single A rated bond, it's actually positive by about 1.3% on the year. What you're really referring to, or what people's sensitivity is, is really the high-yield portion of the municipal cash bond market, and that makes up about 4 or 5% of the overall market. And it's fair that that market is right now down between say 3-5% depending on the instrument or proxy that you're looking at. So there's scope for the high-yield market to repair with the help of the government policies that were enacted, and that should lead to one of those revenue streams over time acting as a positive tailwind.

The second one and the most interesting one to me is that closed-end funds, as you know, use a moderate amount of leverage to acquire more assets to pay higher distribution yields. And since May, really just a month or so ago, we have seen two rounds of distribution rate increases in the municipal bond closed-end fund sector. I know that runs a bit counterintuitive to things, but it's actually a really large positive given that interest rates and U.S. treasuries have come down by a fair amount and are almost making new lows as we speak. So give you a yardstick, the sector yield has risen to about 5% relative to about 5.7% historically. So I expect distribution rates to climb back to the long-term average, especially as the market recovers in general or time heals the wounds of the pandemic over the next six to nine months. And then finally since we're speaking about the wrapper of closed-end funds, the Federal Reserve cut interest rates to what's called the ‘effective lower bound'. By doing that they created a significant tailwind for fixed-income closed-end funds because their financing costs have dropped materially. So mechanically, those cost savings are passed onto shareholders in the form of higher distribution yields. That typically results in the discount to net asset values tightening as the relative yield between a closed-end fund and a traditional cash fixed-income product widens. We see that happening here. And when you think about this combination of potential for broad discount to NAV tightening, a new mini trend, where we've seen two rounds of distribution rate increases. And then the potential for the cash bonds to recover with the government's support, you have what I would view as an above average total return potential looking out 12 months. And that's an interesting combination as I said at the beginning, it just doesn't show up that often.

CHUCK JAFFE: It doesn't. Thanks so much for explaining it and spending the time with us, we hope to chat with you again down the line in The NAVigator.

NEIL AZOUS: Thank you very much, Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I'm Chuck Jaffe and you can check out my show on your favorite podcast app or at MoneyLifeShow.com. To learn more about closed-end funds and business-development companies, go to AICAlliance.org, the website for the Active Investment Company Alliance. On Facebook and LinkedIn @AICAlliance. Thanks to my guest, Neil Azous, chief investment officer at Rareview Capital in Stamford, Connecticut. Find his commentaries and learn about the firm at RareviewCapital.com. The NAVigator podcast will return to its regular Friday release date next week. We hope you'll rejoin us on July 10th. Until then, enjoy the July 4th weekend and please stay safe everybody.

Recorded on July 1st, 2020

To request a particular topic for The NAVigator podcast please send an email to:

TheNAVigator@AICalliance.org

Click the link below to go to the home page of Active Investment Company Alliance to learn more: https://AICalliance.org/

Disclosure: *Listed closed-end funds and business development companies trade on exchanges at prices that may be above or bellow their NAVs. There is no guarantee that an investor can sell shares at a price greater than or equal to the purchase price, or that a CEF's discount will narrow or be eliminated. Nonlisted closed-end funds and business development companies do not offer investors daily lliqudity: often on a small percentage of share on a quarterly or semi-annual basis. CEFs often use leverage, which can increases a fund's risk or volatility. The actual amount of distributions may vary with fund performance and other conditions. Past performance is no guarantee for future results.*