Tax Edge Makes Munis Attractive Even As Discounts Shrink

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Chuck Jaffe, in this episode of The NAVigator podcast interviewed Patrick Galley, chief investment officer at RiverNorth Capital Management—which runs four municipal bond closed-end funds that invest in both individual bonds and in other muni closed-end funds. Read the Q & A below as Patrick says that as tax-equivalent yields in the muni space have become relatively attractive, the supply-demand picture has changed, narrowing discounts. That doesn't diminish the tax edge provided by the bonds, but makes selective buying critical for investors looking for tax advantages now.

Dan Omstead

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

CHUCK JAFFE: We're talking muni bond investing in a time of rising inflation and interest rates with Patrick Galley, chief investment officer at RiverNorth Capital Management, let's NAVigate. This is 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 is 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. If you're looking for excellence beyond indexing, The NAVigator's going to point you in the right direction. And today, well, it's pointing us in the direction of

RiverNorth Capital Management and their chief investment officer, Patrick Galley. Now the interesting thing is that RiverNorth is both a fund sponsor and a closed-end fund buyer. Because there are multiple RiverNorth funds, and today we're going to be talking about their muni funds, RiverNorth Opportunistic Municipal Income, Managed Duration Municipal Income, Flexible Municipal Income, etcetera, but a portion of that portfolio is a closed-end fund investing in other closed-end funds. If you want to learn more about how it works, go to RiverNorth.com. If you want to learn more about investing in closed-end funds and business-development companies go to AICAlliance.org, the website for the Active Investment Company Alliance. Patrick Galley, thanks for joining me again on The NAVigator.

PATRICK GALLEY: Thanks Chuck, thanks for having me.

CHUCK JAFFE: Let's start with an overview of muni bonds, because this is a space that hasn't been getting a lot of talk, but Lord knows, anything that's interest rate related right now and anything that is sensitive to inflation is at least being talked about and kicked around, and people are trying to decide where they're at. So where are you on muni bonds in a time of rising interest rates and rising inflation?

PATRICK GALLEY: Yeah, I think on the rising inflation front there's obviously interest rates rising, I think you do get a mixed bag of those that are in a transitory environment or not. But at the end of the day I think more the story with muni bonds is the tax environment, and with the new administration, what's going to happen next year with rates rising. And so sheltering from increase in taxes obviously is on everybody's mind, and I think obviously munis can deliver there regardless of rising interest rates or inflation. So as far as fixed income goes, I think there's still a ton of interest for muni bonds, and especially for muni closed-end funds, and you can see that from the discounts on the muni bond closed-end fund space and the recent narrowing that we've witnessed there.

CHUCK JAFFE: That recent narrowing, obviously the thinner the discount gets, the less attractive closed-end funds. And at RiverNorth, one of the things that you do is kind of make the decision of how much are we investing in bonds versus how much are we investing in closed-end funds? Now you've got a subadvisor to do that actually bond selection, MacKay Shields does that for you, but have you found in this market as discounts narrow that you want to do less with the funds and more with the paper itself?

PATRICK GALLEY: Yeah, naturally our strategies are tactically designed to be able to increase closed-end fund exposure when discounts are wider and decrease closed-end fund exposure as discounts narrow, and rotate that taper or that tactical allocation in and out of the closed-end funds and into cash funds. And as you described, MacKay Shields, MacKay Muni Managers is managing that cash bond portfolio and we're tactically managing the municipal bond closed-end fund allocation. And so as discounts narrow, yeah, you typically are reducing that closed-end fund allocation and increasing the allocation to municipal bonds directly.

CHUCK JAFFE: As for muni bonds themselves, there was a lot of talk as we entered the pandemic that munis would be hurt. Because you had communities, some places that had been struggling like Chicago or Illinois, the state and the city, where you got a lot of revenue that normally comes from tourism related stuff, that's all going away. And we had some municipalities that were struggling and were on the edge and now they were going to see less in revenues, but none of that has seemed to play out. So why have the munis been able to avoid trouble, and can they continue? Is that part of the reason why this is a sweet spot?

PATRICK GALLEY: Yeah, I mean obviously the federal support and the cash just coming in from the federal government to support everybody under the sun, including municipalities, I think was tremendous and provided essentially a backstop. And that backstop I think made municipal bond investors comfortable, which then even more so made the bonds re-financeable as those rates dropped and yields have come in and spreads have come in to treasuries. And so there's actually a flood of money coming into the municipal closed-end fund space, and I would say even foreign investors as well coming into the municipal bond closed-end fund space, and even other investors such as insurance companies as well. So other institutional investors, just not mom and pop looking for tax free income. So you've seen that supply and demand imbalance if you will, where there's less supply of municipal bonds themselves, and more demand which is obviously squeezing spreads and increasing prices.

CHUCK JAFFE: The funds that RiverNorth has in the muni space, RiverNorth Opportunistic Municipal Income versus their Managed Duration Municipal Income, RMI versus RMM on the ticker symbols, versus the Flexible Municipal Income funds. Obviously there are different ways to play munis, and there are different areas in the space, and I know these are all your children so you don't normally pick a favorite. At the same time, as you look at munis and you're making the decisions about where you're going to allocate monies, help my audience understand the difference, what is opportunistic municipal versus the flexible municipal? And what are the areas where you think in the muni space, this is where you want to particularly get your coverage?

PATRICK GALLEY: Yeah, I think the two you pointed out directly, RMI and RMM, the distinction there, RMM in its name is the managed duration strategy. And so we are managing the duration plus or minus three years, by prospectus plus or minus three years to the benchmark. And so the duration there is being hedged, predominantly using treasury futures to hedge durations. And again, we at RiverNorth or MacKay, we don't try to make tactical calls based off of our expectation of where rates are going, I think that's pretty tough to time and get right consistently. But what we're trying to offer to investors, depending on their views and what their goals are from an investment standpoint is that they have the opportunity to invest in the case of just those two, two tactical funds, each investing in closed-end funds and each investing in municipal bonds directly, but one's going to be more hedged and have more duration. So frankly, RMM, the managed duration strategy did not do that well during the pandemic. As treasuries plummeted and those yields plummeted, that hedge was a negative detractor. But as rates have increased recently, that fund has tremendously rebounded and has surpassed the performance of the counterpart RMI. Which it does have actually a hedge as well, it's just not as much of a hedge as RMM. And then the flexible strategy, that's really where we as portfolio managers have more flexibility from the duration, we're not constrained on the duration side, we're also not constrained, we have more flexibility on the credit side as well. Giving MacKay Shields as a good example, in 2021, making more of a tactical call towards lower credit quality municipal bonds and having that play out as lower credit quality municipal bonds rallied more as the higher quality. And so the flexible strategy being RFM and RFMV, which is really the RiverNorth Flexible Municipal Income fund too, gives investors more of a hands off approach and giving us as portfolio managers more flexibility to tactically manage those strategies.

CHUCK JAFFE: Obviously you're selling muni funds, just out of curiosity, given the muni market what your outlook is and the rest, how much of a bond portfolio would you think munis should be? Because for some people they are bedrock, they're a huge piece of it, for others they're kind of a taste.

PATRICK GALLEY: That's a great question. Obviously I think a lot of that would have to do with your tax bracket, and if you can pick up the highest tax equivalent yield, it's really difficult to invest in other fixed-income securities. You would have to stretch from a credit quality standpoint to get to similar tax-equivalent yields that municipal bonds offer. So I think there's a great place you could have a very, very diversified portfolio over municipal bonds. You can even have some high yield if you want in the municipal bond arena, but have the benefit of very attractive tax-equivalent yields compared to taxable fixed-income securities. So we think for those in the highest tax bracket, that a significant allocation of their fixed income makes a ton of sense. And then obviously we might be biased, but we think obviously a taxable allocation to closed-end funds makes sense as well. You get additional yield pickup, but most importantly from our perspective you get the benefit of being able to generate additional total return from tactically allocating the closed-end funds, especially when those discounts are attractive.

CHUCK JAFFE: Patrick, thanks so much for joining us. Let's do this again and talk about other parts of the closed-end funds in the investment world.

PATRICK GALLEY: Thanks Chuck.

CHUCK JAFFE: The NAVigator is a joint production of the Active Investment Company Alliance and Money Life with Chuck Jaffe. I am Chuck Jaffe and you can learn about my hour-long weekday podcast on your favorite podcast app or at MoneyLifeShow.com. To learn more about interval funds, 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, Patrick Galley, the chief investment officer at RiverNorth Capital Management, the president and chairman of the RiverNorth funds. Learn more about the firm and its funds at RiverNorth.com. The NAVigator podcast is new every Friday, follow along on your favorite podcast app and come back next week to learn more about investing with closed-end funds. Until next time, happy investing everybody.

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