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Muni Fund Investors Squeezed as Flattening Curve Reduces Payouts.

Investors who've come to depend on steady income checks from leveraged municipal-bond funds are starting to feel the pinch from the narrowing in the difference between short- and long-term borrowing rates.

BlackRock Inc., Nuveen Investments Inc. and Eaton Vance Corp. earlier this month made widespread cuts to distributions in their closed-end funds as the cost to borrow to boost returns rose and higher yielding bonds held were called as longer-term rates fell. The three companies are among the biggest providers of closed-end funds.

UBS Financial Services, Inc. said in a June 16 report that it couldn't "recall a period in recent memory when so many funds cut distributions at one time." The cuts, which only affected leveraged funds, ranged from 2 percent to 15 percent, UBS said.

"In the flattening yield curve environment, add in the higher cost of leverage, a lot of these funds haven't been able to maintain their high payouts," said Ryan Paylor, a portfolio manager at Thomas J. Herzfeld Advisors, Inc. in Miami.

Closed-end funds raise a fixed amount of money from shareholders in a public offering, unlike mutual funds, which continually sell and redeem shares. Closed-end funds are traded on stock exchanges and can trade at premiums or discounts to their net asset value. Open-end mutual funds trade daily at their net asset value.

Most municipal closed-end funds borrow short-term and buy long-dated debt. The weekly benchmark for yields in the variable-rate tax-exempt bond market surged in March from 0.02 percent to 0.4 percent as investors tapped muni money-market funds to pay taxes.

In the last 12 months, the three-month London interbank offer rate, or Libor, has increased to 0.64 percent from 0.28 percent. The Federal Reserve raised its target rate for overnight loans between banks in December for the first time since 2006.

The slope of the municipal yield curve has flattened to the lowest in more than eight years as investors, including foreign buyers in search of higher yields, have poured money into municipal bond funds for 38 consecutive weeks, according to Lipper data. While short-term rates have risen, the demand helped push 30-year tax-exempt yields to a record-low of 2.23 percent on June 16.

"Because municipal bond yields are so low, as funds have bonds called away they can't be reinvested at the same rate," said Sangeeta Marfatia, a UBS executive director for closed-end fund research. "They're reinvesting the proceeds at lower rates and that's putting pressure on the earnings too."

On June 1, BlackRock said it cut distributions on 38 of its 52 closed-end muni bond funds, according to a news release. Eaton Vance cut distributions on 11 of 21 funds. Nuveen cut 17 of 55.

The average distribution yield for municipal close-end funds is 5.2 percent, a decline from 5.8 percent at the beginning of the year, Paylor said.

“If we get another rate rise and the curve flattens even more it’s going to be really tough to sustain their dividends,” he said.

Despite the cuts, share prices have gone up. National, New Jersey and New York leveraged funds were up an average of 10 percent in terms of market returns through June 10, compared to their net asset value returns of 6 percent, according to UBS.

After the “Taper Tantrum” in May 2013, when then-Fed Chair Ben Bernanke jarred bond investors with plans to scale back asset purchases, muni closed-end funds traded at a discount to net asset value of more than 13 percent on average, Paylor said. Now they trade at a 1.7 percent discount.

“Muni investors usually are the type that like to chase returns, especially in the closed-end funds space,” Paylor said. “As a result they’re pushing these things towards premiums.”

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