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The Time Is Now For Muni CEFs.

A bargain hunter's dream. That could be the best way to describe the current fixed income market. Yes, the Fed has been raising rates and that has sent many varieties of bonds and securities lower as yields readjust to the current rate environment. But in that readjustment, some fixed income securities have now been reset to more historical norms when it comes to yields and pricing. A few, perhaps, have even moved into bargain territory when considering their other benefits.

In this case, we are talking about municipal bond closed-end funds (CEFs).

By combining the tax-free nature of munis with the power of already buying at discount/higher yields of a CEF, investors are looking at a very interesting package. And it could see serious benefits down the road.

CEFs & Munis: A Match Made in Heaven

With exchange traded funds (ETFs) taking the world by storm, a variety of other investment vehicles have been placed on the backburner. One of them continues to be the humble closed-end fund (CEF). CEFs are a throwback to the early days of investing, with the fund type being older than mutual funds. Some of the earliest days of the CEF date back to the beginning of the 1900s.

These quirky investment vehicles blend mutual funds and ETFs into one asset class. CEFs trade on major exchanges just like ETFs and can be bought/sold throughout the day. However, the kicker is that, unlike an ETF, their value is dictated by supply/demand. They have a fixed number of issued shares, so it is the whims of investors that determine how much people pay for a share of the CEF. That means they can and often trade at discounts to their underlying net asset values. For example, investors can buy one dollar worth of assets for 80 cents or so.

Because they trade on an exchange, managers of the funds do not have to worry about redemptions or money flowing out of the fund. Therefore, they can buy long-term or more illiquid asset classes. This fact has made them a haven for certain kinds of fixed income securities—in this case, municipal bonds.

Muni bonds generally have long-term timelines until maturity. By placing it in a CEF, managers can hold the bond until it comes due without having to worry about selling bonds—potentially at a loss—to meet investor redemptions. The added bonus is that CEFs are allowed to use some leverage to boost their returns. This provides higher yields than a mutual fund or ETF. Because of muni's tax-free nature, when placed in a CEF, this can provide tax-advantage yield north of 5 to 7%.

An Interesting Time to Buy

Currently, this match made in heaven has a lot of appeal for investors. Thanks to the Fed's monetary policy of raising rates, many fixed income securities have begun to drop. Bonds have an inverse relationship with rates. The longer the maturity of the bond, the bigger the drop. And munis have been hit hard.

For the first half of the year, muni bonds posted one of the worst drawdowns in history. According to Bloomberg data, the sector is on track to post a loss of 9.5%, the worst year since 1981. However, in recent months, the pain has begun to stabilize. So-called yield tourists are now gone and more serious long-term investors—like insurance companies, pension funds, and high,net,worth investors—have begun buying.

The reason for buying?

Munis currently offer tax-evident yields north of 5%. That's currently higher than any other bond category, even Treasuries. That tax-equivalent yield is particularly attractive considering the stability and financial backing of these bonds. Why buy a junk bond issued by a tech startup and get a lower yield, when you could buy a muni issued by a state with the ability to raise taxes to keep interest payments going.

Moreover, the long-term tax-benefits could be greatly underestimated by the markets. The Biden Administration has made higher taxes for high-income earners a cornerstone of his fiscal policy. While it remains to be seen if those tax hikes come true, the potential is there. And that could make munis very much in demand for the long haul.

Considering all of this, CEFs holding munis may be the best bet for investors. Thanks to the sell-off, muni bonds have already been discounted by the market as evident by their sky-high yields. The win is that the average muni CEF is now trading at discounts to NAV not seen since the Great Recession. For example, the Nuveen Municipal Value Fund (NUV) —which is one of the largest CEFs in the sector—can be had for a 5% discount to its NAV. Meanwhile, the $1.16 billion BlackRock MuniHoldings California Quality Fund (MUC) can be had for a nearly 9% discount to NAV. And they are not alone in their big discounts to their underlying values.

Buying Some Muni CEFs

Given the high yields, major tax benefits, and the huge discounts available on their shares, investors may want to consider adding muni closed-end funds to their income portfolios. Just like ETFs and mutual funds, there are a variety of CEFs to choose from. Investors in high tax states like New York or California may want to choose state-specific funds to save even more on taxes. Others focus on 'values' within the sector. The key may be to buy a few different funds to meet income objectives.

The thing to focus on is buying at a discount and making sure the fund has decent volume/using limit orders for purchases. This will ensure you're actually getting the best price and that the fund won't merge away, something that happens to many CEFs when assets/volume are low.

The Bottom Line

Munis are offering a huge opportunity right now and closed-end funds remain the best way to access that prospect.

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