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Municipal Bond Funds Are on Sale. Buyers Should Be Cautious.

Many closed-end municipal bond funds are selling at big discounts to their net asset values, offering some interesting opportunities and nice yields—though investors need to be careful.

"If you are more selective and you are going to own these [funds] for the long term, there is probably some value," says Sangeeta Marfatia, senior closed-end fund strategist at UBS Global Wealth Management.

Closed-end funds, which trade on an exchange, often use leverage to boost their returns. In theory, investors can benefit several ways. There's the total return, including the yields, of the fund's holdings — and the price appreciation of the shares. Price discounts can provide some measure of safety.

In 2018 many of these closed-end funds have fared much worse than the overall municipal bond market, which is down roughly 1%. As a result, numerous closed-fund muni funds trade at wide discounts to their net asset values. The accompanying table lists five.

One factor that's pressured prices is tax-loss selling, says Marfatia. Investors can pare their losses with gains to reduce their tax liability. With rates moving up, funds that use leverage face higher borrowing costs as well. And some funds have had to cut their distributions.

In July, for example, BlackRock announced it was cutting the monthly distribution for the BlackRock Municipal Income Investment Quality Trust (BAF) from 6.85 cents a share to 5.85 cents. "The distribution change was made in order to better align the fund's distribution rate with its current and projected level of earnings," according to a BlackRock spokesperson.

The fund was recently yielding about 5.6% and trading at nearly a 14% discount to its net asset value, according to CEF Connect. Its one-year price return was recently minus 12.3%, but its net asset value had returned minus 1.7%.

It was hardly alone in cutting its distribution.

"Many of the funds in this sector have been reducing dividends and while it is factored into the market on some level, it's important for investors to be aware of the possibility," Jonathan E. Lewis, chief investment officer at Fiera Capital, noted this week.

The good news is that among fixed-income sectors, "muni closed-end funds may be one of the best values available," asserts Lewis.

He points out that the 40 closed-end funds in which Fiera invests are trading at about a 14% discount to their net asset value, compared with an average discount of 5.4% since late 2004. The entire universe of these funds — about 180 in total — is trading at about an 11% discount — the cheapest level since the financial crisis, says Lewis.

Lewis, who advocates holding a basket of these funds as a diversification tool, says these discounts could narrow.

One possible outcome: “If rates are near an intermediate-term top, retail investor sentiment becomes positive in a search for yield,” he observes. These funds are predominately held by retail investors.

Under such a scenario, he says, investors could still earn a 5% yield and get some price appreciation, possibly bringing a 10% total return over the next 12 months. It’s important to remember that a 5% yield on a municipal bond is equivalent to a higher yield on a taxable credit. That’s because the interest on munis is exempt from federal taxes and often from state and local levies as well.

Of course, if rates continue to rise, it would pressure bond prices and the returns of these funds. And these funds can be volatile. “If somebody decides to sell a big position, they are going to take the price down,” says Marfatia.

Barron’s

By Lawrence C. Strauss

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