



A Compelling Opportunity in Municipal Bond Closed-End Funds

Barring a miraculous comeback, 2022 will go down as one of the worst years for municipal bond investors in several decades. In fact, the Bloomberg Municipal Bond Index (Municipal Bond Index) was down over 12% year to date through the end of September and municipal bond closed-end funds (CEFs) (as measured by the First Trust Municipal Closed-End Fund Total Return Index (FT Muni CEF Index)) fared even worse dropping by 28%. We believe this carnage has created a rare opportunity in municipal bond CEFs.

Municipal bond CEFs are registered investment companies that post a net asset value (NAV) each night like an open-end mutual fund, but trade on an exchange like an exchange traded fund. This unique structure frequently causes differences between the price of the security and the underlying value of its holdings. If the CEF trades above the NAV, it is trading at a premium. However, if it trades below its NAV, it is trading at a discount. The wider the discount, the higher the yield an investor receives and the greater the potential for appreciation as the discount closes.

Looking at the discounts of the CEFs comprising the FT Muni CEF Index since the beginning of the year through October 20, 2022, the average discount has widened from 0.73% to 8.94%. In our experience, municipal bond CEF discounts are mean reverting and do not tend to stay extremely wide or narrow for extended periods of time. The average discount is currently 6.35% wider than its long-term average from 2005-2022. In fact, the average municipal bond CEF's month-end discount (as measured by the discounts of the constituent CEFs within the FT Muni CEF Index) has only been wider than it is today in 5 of 196 instances since 2005.

Taking a look at historical go-forward returns from various discount levels in Table 1, it is evident that go-forward returns from municipal bond CEFs (as measured by the discounts of the constituent CEFs within the FT Muni CEF Index) generally increased when they were purchased at wider discounts. Importantly, in each instance when the average discount was greater than 8%, go-forward returns were positive for each of the 6, 12, and 24-month time frames.

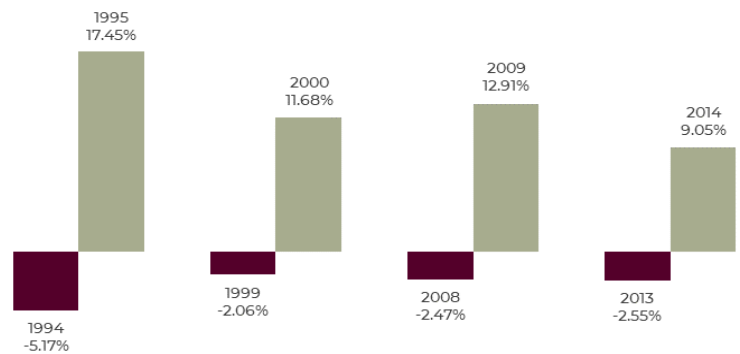
Table 1. Municipal CEF Average Discount Ranges & Subsequent Returns for 6, 12 and 24 months (12/31/2005 – 9/30/2022)

Average Discount Range	Subsequent Municipal CEF Returns		
	6-Month	1-Year	2-Year
10+	17.89%	27.61%	16.58%
9% to 10%	14.51%	37.17%	22.40%
8% to 9%	8.13%	17.26%	8.95%
7% to 8%	5.73%	12.36%	8.67%
6% to 7%	7.02%	9.66%	7.07%
5% to 6%	4.73%	8.23%	5.48%
4% to 5%	4.46%	7.05%	7.88%
3% to 4%	2.25%	6.95%	6.74%
2% to 3%	3.02%	4.06%	6.72%
1% to 2%	0.70%	6.68%	4.19%
0% to 1%	-3.25%	-3.94%	1.06%
Premium (>0%)	1.07%	3.36%	4.46%

Bloomberg Finance, L.P. Based on total returns of the First Trust Municipal Closed-End Fund Total Return Index in periods for the average discount ranges indicated. Past performance is no guarantee of future returns.

Negative years in the Bloomberg Municipal Bond Index have been few and far between. In fact, the Bloomberg Municipal Bond Index has only produced negative returns in 4 out of the last 40 calendar years, ending 12/31/2021. Although past performance is no guarantee of future returns, the year subsequent the rare negative year has averaged a 12.78%.

Chart 1. The Worst Negative Annual Total Returns and Subsequent Year Total Return of the Bloomberg Municipal Bond Index (12/31/1981 - 12/31/2021)



Bloomberg Finance, L.P. Bloomberg Municipal Bond Index. Past performance is no guarantee of future returns.

This historically bad year for municipal bonds and especially municipal bond CEFs has, in our opinion, caused the asset class to go from overvalued to extremely undervalued in 9 months. Given all of the items outlined above, we feel that municipal bond CEFs now offer a compelling opportunity to investors.

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Sources: Bloomberg Finance, L.P., First Trust

Index definitions: The Bloomberg Municipal Bond Index covers the U.S. dollar denominated long-term tax-exempt bond market. As of 12/31/2021, the index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and prerefunded bonds. Details about the First Trust Municipal Closed-End Fund Total Return Index can be found here: <https://www.ftportfolios.com/Retail/Index/IndexSummary.aspx?IndexID=154>. Data provided by Bloomberg Finance, L.P.

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