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Is high yield high risk?

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As the economy slows and possibly moves into recession or soft landing in 2024, we expect occasional headlines highlighting the fiscal stress on municipalities. Investors are concerned about the impact of higher inflation and slower revenue collections on government budgets. While these topics are important for the high-quality investment space, high yield municipal bonds typically fund essential services entirely separate from governmental operations that are financed by general obligation bonds (GOs). Therefore, high yield investors are paying closer attention to issues such as a project's economics and competitive position.

HIGH YIELD MUNICIPAL BONDS ARE PRIMARILY PROJECT BONDS

High yield municipal bonds are not GOs, for the most part. They are primarily project bonds that provide an element of essential service that is financially independent from the city, county or state they serve. These revenue bonds tend to offer higher yields to compensate investors for the risk and uncertainty associated with a project, such as construction risk, political/ governance risk and third-party risk.

That means that the high yield municipal bond market is generally not concerned with issues typically associated with GOs — managing public services, balancing budgets and funding pension costs. Rather, high yield investors pay close attention to a project's economics and competitive position, as well as security features such as:

- A revenue pledge, which provides a security interest in the revenues generated by the project.
- A limited tax revenue pledge, where only those tax revenues pledged to debt service support the bonds.
- Any debt service or project-based covenants which, if violated, could accelerate rights of the bondholders.
- A first mortgage lien on property or other assets.
- Other forms of security interests in the real estate or project.

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These features, along with higher yields, help compensate investors for the added risk.

These forms of security are not provided for high-quality GO bonds, as the revenue pledge backing GOs allows for unlimited taxing authority to cover debt service. Substantial credit monitoring is still required, but these credit strengths put high quality GOs and associated revenue bonds solidly in the investment grade rated category. Since high yield municipal bonds often have security features such as liens on land, tax liens on the project and/or security interest in the revenue stream, more potential remedies exist in the event of distress or default. These remedies potentially provide more protection than those found in similarly rated corporate high yield bonds, which are often subordinated in the capital structure of a high yield issuer.

Lastly, high yield municipal bonds often relate to an element of essential service that provides a strong level of credit support.

HIGH YIELD MUNICIPALS CROSS MANY SECTORS

High yield municipal credit sectors can be characterized in numerous ways. Some credit factors cut across sectors, such as whether a bond holder is secured by a first mortgage lien on the land or an annual appropriation pledge (a taxing entity's promise to appropriate funds). However, the major credit sectors can be broken into various profiles:

Tax backed. A tax associated with land or infrastructure development generates revenues for repayment. Subtypes include special assessment districts, community development districts, redevelopment districts, infrastructure development and public improvement districts. Some projects in this sector are referred to as "mud" districts or "dirt" deals, indicating various stages of above-ground development. Many of these projects also include a lien on the above-ground project. These credits can range from very risky projects with limited initial development to fully developed projects with diversified sources of tax payments from an array of landowners and residents who have subsequently moved into the district.

***Headline risk can affect liquidity** and may be triggered by events that have nothing to do with actual credit factors.*

Health care. These projects range from hospitals or hospital systems to nursing homes and congregate care facilities. These credits are typically rated anywhere from AA+ to B- and below. Although size is not the determining factor, some larger, diversified health care projects fall into the mid-investment grade space, while smaller, less financially flexible stand-alone facilities tend to be higher yielding and lower-rated credits. Health care is being impacted by many factors, including an aging population, increasing expenditures from much higher wages, and the federal regulatory environment. As a result, these bonds require intense and ongoing credit analysis. Many health care credits can be evaluated like corporate credits, with balance sheets, income statements, endowments, real estate and other assets.

Education and charter schools. Similar to health care, credits in the education sector span the ratings spectrum from AAA-rated Harvard University to high yield credits such as small, private colleges or charter schools. Evaluating these credits requires knowledge of enrollment trends and intense focus on operating and balance sheet metrics (debt service coverage, operating leverage and liquidity cushion). Bondholder security is another key part of the analysis, with attention to legal protections, such as a mortgage or revenue pledge, and financial covenants.

Transportation and toll roads. These revenue bonds are repaid by tolls or facility rental fees from a public transportation system (e.g., toll roads, airport gates). Debt service repayment depends on facility usage and project management.

Tobacco. Tobacco settlement bonds are repaid by revenues from the Master Settlement Agreement between various states and participating tobacco manufacturers. The payments by the tobacco companies to the

states are determined by a multi-variable formula heavily based on cigarette consumption. Therefore, one risk is that domestic sales of cigarettes may decline further than declines assumed in the various bond documents. Some of these bonds carry investment grade ratings, but the market generally trades these as high yield bonds.

Industrial development and pollution control. Many of these projects depend on repayment from large industrial firms, with the bond proceeds meeting the public purpose to create jobs and/or reduce pollution. This sector is very similar in credit profile to the taxable high yield space, and sometimes a company will have bonds issued in both marketplaces.

Other sectors. High yield municipal bonds can also include financings for convention centers, Native American Tribal gaming facilities, utilities (including water and sewer facilities), multi-family housing and other smaller credit sectors.

LIQUIDITY REMAINS A RISK

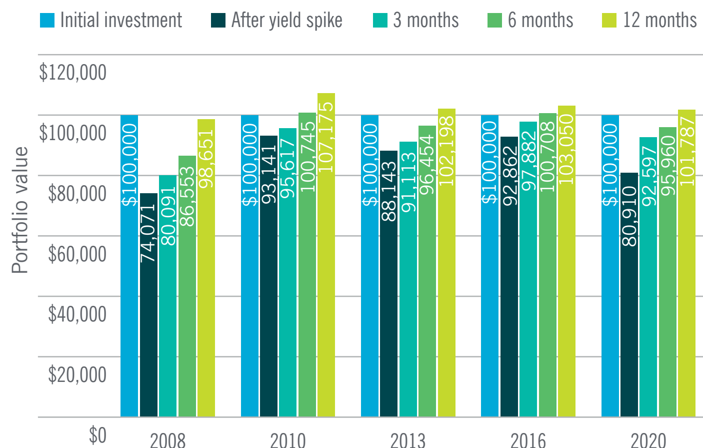
Liquidity is a risk in the high yield municipal marketplace. Headline risk can affect liquidity and may be triggered by events that have nothing to do with actual credit factors. For example, high yield municipal prices fell dramatically in 2008 even though the vast majority of high yield municipal bonds continued to pay interest and principal when due. In late 2010, an analyst forecasted a rapid increase in municipal bond defaults within cities and counties, causing a selloff in high yield municipals. In reality, defaults had actually begun declining from their post-crisis peak. During the coronavirus pandemic in 2020, limited defaults in the high yield market mainly affected nursing homes and congregate care centers. However, even these defaults were spread out over time and space and contained mostly to this single sector. Because these credit issues can be misunderstood and the bonds are often thinly traded, headlines and other factors can impact liquidity – an inherent risk in the high yield municipal bond market.

PORTFOLIOS WERE EVENTUALLY COMPENSATED FOR PATIENCE

In times of elevated market volatility or negative press, investors may decide to sell and wait for conditions or valuations to improve before reallocating funds. But most cannot time the market perfectly, which can mean lost opportunity.

Prior to the selloff induced by the U.S. Federal Reserve beginning in 2022, there had been five periods where municipal yields increased by at least 100 basis points in less than one year. We examined the total return of a hypothetical investment of $100,000 held for 3-, 6- and 12-month periods following each spike. In holding periods of 12 months or longer, staying the course benefited investors. We are now monitoring how the high yield market will recover from the inflation-based/Fed tightening selloff of 2022, giving us a sixth period to test the market's ability to bounce back from investor outflows.

Figure 1: Portfolios fully recovered principal after each yield spike



Data source: Bloomberg, L.P. Based on returns of the Bloomberg High Yield Municipal Bond Index. **Past performance is no guarantee of future results. High yield municipal market time periods: 2008:** 11 Sep 2008 – 19 Dec 2008; **2010:** 25 Oct 2010 – 14 Jan 2011; **2013:** 22 May 2013 – 09 Sep 2013; **2016:** 09 Sep 2016 – 01 Dec 2016; **2020:** 28 Feb 2020 – 20 Mar 2021. Time periods represent high yield market highs/lows for each rising rate period. For the 2020 period, the 12-month data is not yet available.

MISUNDERSTANDING MAY CREATE VALUE

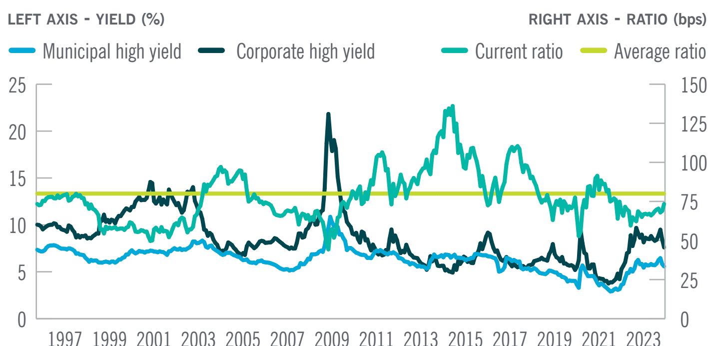
Municipal credit has continued to prove resilient during periods of market disruptions, with the most recent example being the coronavirus pandemic. Municipalities have not only recovered from this crisis, but metrics are even stronger.

Media attention on high profile credit situations leaves many investors concerned about the overall state of municipal GO credit quality. However, in this cycle, high quality municipal bonds are well prepared for a fiscal slowdown. Reserves stand at all-time highs, and tax receipts remain robust despite some declines. Therefore, the media is less focused on high quality municipal credit than in the past.

High yield municipals may benefit from these positive perceptions, even though these GO bonds are not typically owned in high yield bond funds. Investors may read about financial problems in cities and hesitate to invest in high yield munis, even though high yield credit exposure is not related to municipal budgets. In this cycle, a stronger bid for high yield may continue, even if the economy weakens somewhat.

Figure 2: High yields in 2023 created opportunities

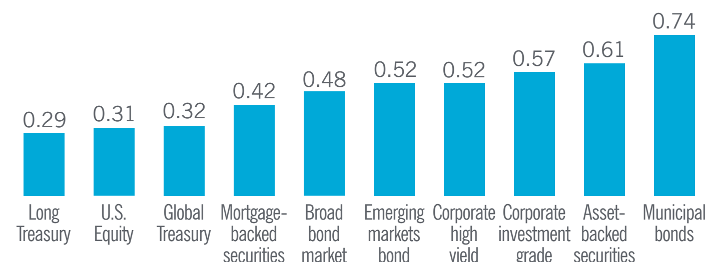
Bloomberg High Yield Municipal Index vs. Bloomberg High Yield Corporate Index



Data source: Bloomberg, L.P., 31 Oct 1995 - 31 Dec 2023. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: high yield municipal:** Bloomberg High Yield Municipal Index; **high yield corporate:** Bloomberg U.S. High Yield Corporate Index. High yield or lower-rated bonds and municipal bonds carry greater credit risk, and are subject to greater price volatility. The taxable-equivalent yield shown is based on the highest individual marginal federal tax rate of 37%, plus the 3.8% Medicare tax on investment income. Individual tax rates may vary. It does not take into account the effects of the federal alternative minimum tax (AMT) or capital gains taxes.

Figure 3: High yield municipals have shown low correlation to other asset classes

Correlation to municipal high yield bonds



Source: Morningstar Direct, 01 Jul 1999 – 31 Dec 2023. **Performance data shown represents past performance and does not predict or guarantee future results. Representative indexes: asset-backed securities:** Bloomberg Asset-Backed Securities Index; **broad bond market:** Bloomberg U.S. Aggregate Bond Index; **corporate high yield:** Bloomberg U.S. Corporate High Yield Index; **corporate investment grade:** Bloomberg U.S. Corporate Investment Grade Index; **emerging markets bond:** Bloomberg Emerging Market Index; **global treasury:** Bloomberg Global Ex U.S. Treasury Bond Index; **long treasury:** Bloomberg U.S. Treasury Long Index; **mortgage-backed securities:** Bloomberg MBS (fixed rate) Index; **municipal bonds:** Bloomberg U.S. Municipal Bond Index; **U.S. equity:** S&P 500 Index.

This misunderstanding may create investment opportunities. The current ratio of high yield municipal yields to high yield corporate yields is 73%, slightly less than the historical average.

Furthermore, high yield municipals have a low historical correlation to other asset classes, making them an appropriate complement to an overall portfolio. The correlation to equities, Treasuries and corporate high yield is generally near or below 50%.

FUNDAMENTAL RESEARCH IDENTIFIES OPPORTUNITIES

Evaluating high yield municipal bonds typically requires understanding issues relating to land or infrastructure development, potential impact on balance sheets and income statements and issues specific to healthcare policy and education. We believe that in-depth fundamental research can help an investor understand risks, identify opportunities and capitalize on the inefficiencies in this misunderstood asset class.

For more information, please visit us at nuveen.com.

Endnotes

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