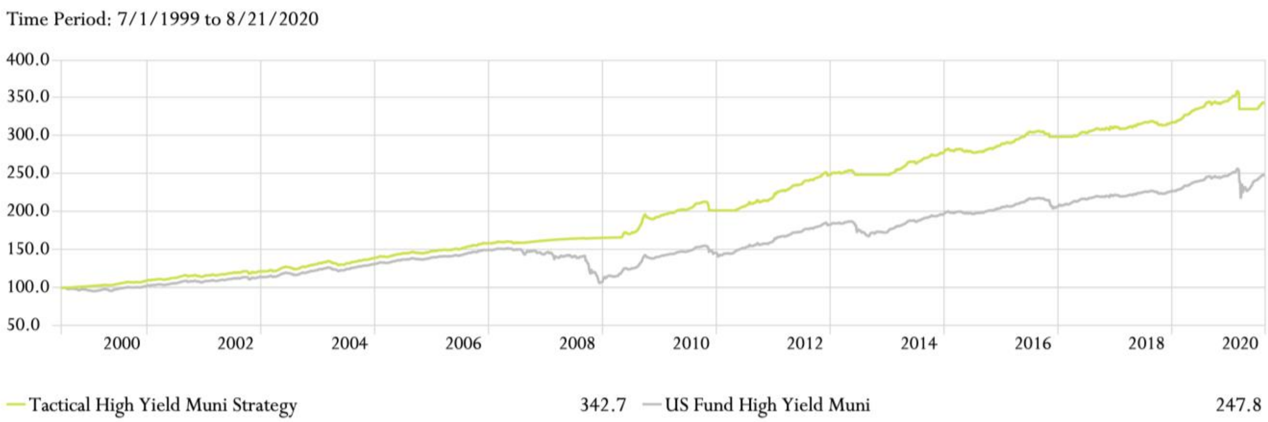
Can you Time Risky Muni Bonds?

The municipal bond asset class shocked investors in March of 2020 by delivering their sharpest drawdown in at least 5 years. In only two weeks, municipal bonds broadly dropped around 15% while high yield municipal bond ETFs fell as much as 35%! This was highly unusual for what investors tend to consider a stable asset class. Amid a year of unusual events in financial markets, this serves to remind investors to consider systematic tactical strategies as a risk-management tool for their municipal bond investments. Tactical trend following is designed to reduce drawdowns, helping to preserve investment capital and keeping investors from making emotional decisions during stressed markets.

Performance: Tactical High Yield Muni vs. High Yield Muni

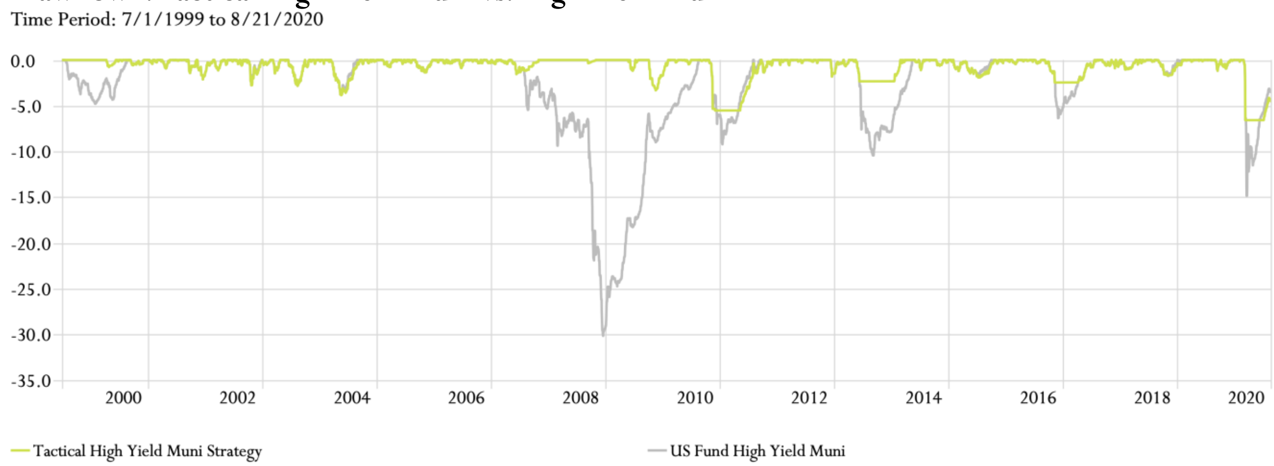


Displayed above is the Morningstar US High Yield Muni Category and the High Yield Muni Strategy, which is defined by buying the Morningstar High Yield Municipal Fund Category when it closes above its 200-day moving average the prior day. The strategy entirely switches exposure to the Morningstar Money Market Tax-Free Fund Category *when the Morningstar High Yield Municipal Fund Category closes below its 200-day moving average.*

The specific source of the 2020 muni bond disruption depends on who you talk to. Some analysts attributed the swoon to a liquidity shortage amid a brief "flight to quality" trade in the bond market. Others attribute the drop to a legitimate sign of future strain on municipal finances as COVID-19 threatened to shut down local economies. Whatever the cause, the sharp drop in muni bond prices accompanied substantial fund outflows. Some investors who traded out of muni funds during the dip were caught wrong-footed – selling right before a sharp rebound.

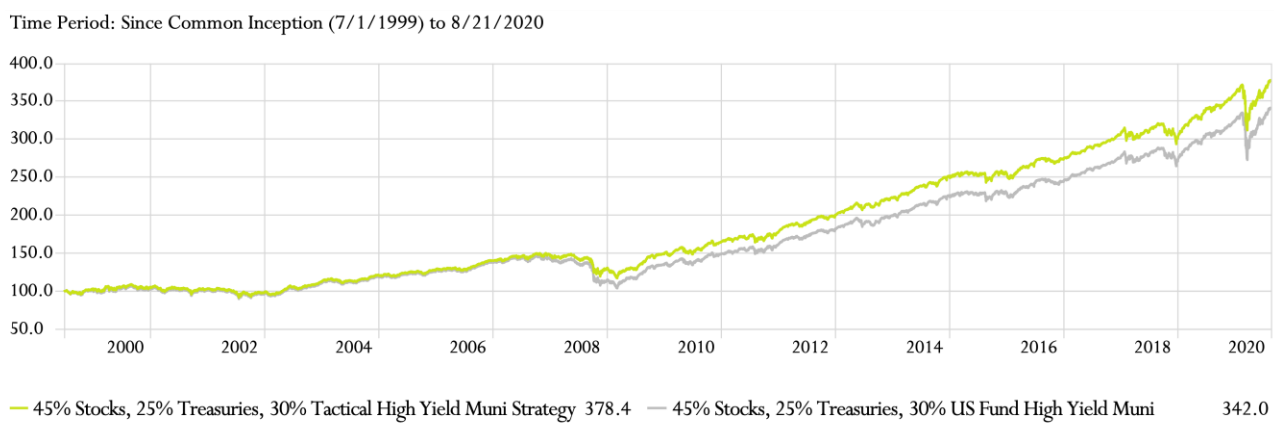
This story highlights the benefit of a systematic risk-management strategy. When markets are unsure how to price the severity of a possible calamity like COVID-19, we believe investors need strategies that seek to avoid trading reactively, harming themselves by selling in a haphazard manner purely motivated by fear.

Drawdown: Tactical High Yield Muni vs. High Yield Muni



Like high yield corporate bonds, high yield municipal bonds have had attractive return profiles relative to their volatility. This quality makes them strong candidates for trend following. Systematic trend following strategies have historically helped reduce portfolio drawdowns without dramatically impacting returns, which has helped improve risk-adjusted performance. As is the case in corporate high yield investing, systematic trend following strategies can position investors to react opportunistically amid price declines. They can also, perhaps more importantly, help prevent investors from responding emotionally to portfolio drawdowns by seeking to minimize those drawdowns in the first place. The potential long-run benefits are brought into sharp relief when you place Tactical High Yield Muni into the context of a balanced portfolio, as can be seen in the chart below.

45/25/30 with Tactical High Yield Muni vs. 45/25/30 with High Yield Muni



Displayed above are scenarios using the S&P 500 Total Return Index to represent "Stocks," the Bloomberg Barclays US Treasury 7-10 Year Index to represent "Treasuries," and a High Yield Strategy in various combinations that are rebalanced annually on July 1st. The Tactical High Yield Muni Strategy is defined by buying the Morningstar High Yield Municipal Fund Category when it closes above its 200-day moving average the prior day. The strategy entirely switches exposure to the Morningstar Money Market Tax-Free Fund Category *when the Morningstar High Yield Municipal Fund Category closes below its 200-day moving average.*

Conclusion

Sharp drawdowns in municipal bonds during the first quarter of 2020 have brought into focus the potential need for proper risk management strategies. By implementing tactical trend following strategies in the high yield municipal bond asset class, investors seek to target reasonable returns while prioritizing reduction of portfolio drawdowns. This tactic can position portfolios to invest opportunistically, and it can help investors avoid the temptation to act emotionally during times of market stress.

Important Risk Information

Investments cannot be made in an index. Unmanaged index returns do not reflect any fees, expenses or sales charges. Past performance is no guarantee of future results. There is no guarantee that any investment will achieve its objectives, generate positive returns, or avoid losses. The Adviser's reliance on its strategy and judgments about the attractiveness, value and potential appreciation of particular securities and the tactical allocation among investments may prove to be incorrect and may not produce the desired results. No level of diversification or non-correlation can ensure profits or guarantee against loss

Index Definitions

The S&P 500 is widely regarded as the best single gauge of large-cap U.S. equities and serves as and captures approximately 80% coverage of available US equity market capitalization. Fixed Income allocation is represented by the Bloomberg Barclays US Treasury 7-10 Year Index, which measures total return of US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury with 7-9.9999 years to maturity. The Tactical High Yield Muni Strategy is defined by buying the Morningstar High Yield Municipal Fund Category when it closes above its 200-day moving average the prior day. The strategy entirely switches to exposure of the ICE BofAML 3-5 Year Treasury Index when the Morningstar High Yield Municipal Fund Category closes below its 200-day moving average.

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