

How Tactical High Yield Municipal Strategies Fit in a Portfolio

We believe investors looking to earn tax-exempt income while actively managing downside risk should consider tactical trend following strategies in high yield municipal bonds. These strategies have historically helped investors reduce portfolio drawdowns while generating reasonable levels of tax-advantaged income.

Tax Advantages

Municipal bond income is generally exempt from federal taxes, a useful feature for investors who hold assets in taxable accounts. A strategy that holds national exposure to high yield munis can distribute pro-rata benefits to reduce taxable income at the state level as well.

Adding Tactical Muni Strategies to a Portfolio

Many tactical trend following strategies seek to reduce portfolio drawdowns while maintaining municipal bonds' tax and return benefits. These strategies often use systematic timing models to invest in high yield munis when they are in an uptrend. They adopt a defensive "risk-off" posture when high yield munis enter a downtrend, shifting to cash or short-term Treasury securities. This can help investors stick with their long-run strategies - even during times of market stress.

Shifting a portfolio from a traditional 60-40 stock-and-bond allocation to include a tactical high yield muni strategy historically helped investors manage stock market risk and portfolio drawdowns. The following chart illustrates the return profile for three hypothetical portfolios from 1999 through 2019: all stocks; 60% stocks and 40% Treasuries; and 45% stocks, 25% Treasuries, and 30% tactical municipal high yield.

Performance: Traditional 60-40 vs. 45-25-30 with Tactical High Yield Muni Strategy

Time Period: Since Common Inception (7/1/1999) to 9/3/2020



Source: Morningstar

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 Tactical High Yield Muni Strategy in various combinations. 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.

Thanks to a strong stock market rally in the past few years, all three strategies have been close from a return perspective: The all-stock portfolio earned 6.48% annually, the 60-40 portfolio 6.41%, and the tactical muni portfolio 6.50%. Since these are pre-tax returns, after-tax benefits are understated for the portfolio with municipal bond income.

Meanwhile, the clearest differentiation for the tactical municipal bond strategy comes in terms of risk mitigation. During the dot-com recession, the Financial Crisis, the Euro crisis, the Shale Bust, and the COVID crisis, the tactical municipal strategy helped support portfolios, compared with more traditional all-stock or 60-40 portfolios.

Drawdown: Traditional 60-40 vs. 45-25-30 with Tactical High Yield Muni Strategy



Source: Morningstar

Reduced portfolio drawdowns may help prevent investors from making emotional decisions that can ultimately impair long-run returns. Lower stock-market risk can help insulate investor portfolios from broad market drawdowns. Tactical muni strategies also helped advisors invest opportunistically, providing opportunities to allocate into assets that may become cheap on a fundamental basis.

Conclusion

Historically, the high yield municipal bond asset class has attractive tax characteristics. Tactical trend following strategies seek to mitigate portfolio drawdowns while retaining many of the benefits of investing in municipal bonds. Investors seeking tax advantaged income and a systematic approach to managing drawdowns should consider tactical asset allocation in high yield municipal bonds.

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 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.

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