Disciplined Research is Key to Helping Navigate the Current High Yield Municipal Market

Key Points:

- High yield municipal bond impairments and defaults are rising YTD
- Late-cycle behavior necessitates prudent research analytics and security selection
- The CNR Municipal High Income Fund team anticipated current dynamics and we believe we are well-prepared ahead of the next downcycle
The ongoing economic expansion improved the success of many high yield (HY) municipal bond issuers with core fundamentals supporting the prospects and performance of their associated projects. According to Municipal Market Analytics (MMA), a provider of impairment and default statistics, the year-over-year change in first-time payment disruptions reached a cyclical low during 2018 (Figure 1). However, the YTD data illustrates a noticeable uptick in issuers experiencing some level of distress that could portend a further rise in material credit events over the near-to-medium term. A recovery that has now become the longest on record, accompanied by strong market technicals, has helped to temper the underlying challenges surfacing in recently issued financings. As a result, we present a set of questions and answers to help stakeholders understand the current climate and how the CNR Municipal High Income Fund team philosophy and credit research process are deployed to potentially counter rising risks within the space and take advantage of market inefficiencies.

**Why are high yield municipal bond defaults rising?**

MMA reported 37 first-time issuer defaults through 3Q19, the most recorded in three years ex-Puerto Rico, and approximately a 20% increase year-over-year (Figure 1). Inclusive of defaults, the level of municipal impairments climbed 30% to 108 incidences through September 30, 2019 YTD (the most since 2015). Recent issuances (within the past three years) accounted for roughly 40% of the technical and monetary defaults. About half of impairments eventually transition into a monetary default, so the rise in impairments should mean defaults are likely to increase over the near-to-medium term, albeit from a low base of current activity.

**FIGURE 1**

**Historical Default Statistics**

Source: Municipal Market Analytics
As of September 30, 2019, HY municipal bonds offered roughly 220 bps of incremental yield over their investment-grade brethren, which hovered near the smallest spread in a decade (Figure 2). The desire for above-market income coupled with tight supply and overwhelming demand for HY municipal bonds (as measured by net capital flows) have fueled highly speculative financings with relaxed covenants and weaker security packages, which narrows the headroom an investor has to intervene when the issuer confronts challenges. Unproven technologies (e.g., a plant that converts plastic waste into fuel) or questionable real estate investments financed over the past two to three years represent some of the deal types approaching their operational phase, with numerous financings meeting the end of capitalized interest (bond proceeds used to make interest payments during project construction) and experiencing episodes of covenant violations. One cautionary observation is the time to default. In 2018, risky sectors, such as industrial development, took about eight months to transition from the initial reporting of trouble to a default, versus ten months in 2017, and 23 months more than five years ago, according to MMA.

**FIGURE 2**
Municipal HY and IG YTW Spread

![Graph showing Bloomberg Barclays Municipal High Yield Index Spread to Bloomberg Barclays Municipal Bond Index with Avg: 321 bps, Min: 113 bps, Max: 636 bps, Std Dev: 103 bps, and 9/30/2019= 220 bps. Source: Bloomberg Barclays Indices]
If current trends persist, what do they mean for investors?

Avoiding credit “potholes” requires rigorous discipline consistently applied throughout a business cycle (Figure 3). Unfortunately, for those investors that failed to apply extreme care with speculative deals marketed into the tight, covenant-light environment, they will find it difficult to recover when the number of impaired credits increases (such as now) and confidence begins to erode. Thorough research and analytics are a laborious undertaking that the CNR Municipal High Income Fund team embraces as a part of its overall portfolio management and security selection framework. The research staff conducts site visits, meets with management, seeks, and in some circumstances, negotiates “bondholder friendly” protections, such as real estate collateral, and meticulously examines the economic viability of the particular project. Ongoing surveillance is a vital component of the operation that effectively reaffirms our forward-looking view of credit and suitability within the portfolio as well as performance attribution. We expect that not “relaxing our credit guard” will reward our fund’s investors over time.

How is the CNR Municipal High Income Fund team positioning its portfolio in the current environment?

The uptick in distressed credits is not a surprise to the CNR Municipal High Income Fund team. The implementation of defensive measures, such as less “risky” sector/security allocation, maintaining credit protections, and raising the overall quality of the portfolio, we believe will serve the fund’s shareholders well during periods of economic and market weakness. Recent trends also suggest opportunities could surface if investor fears lead to softened demand and destabilized liquidity, and fundamentally sound credits become available with favorable risk/return dynamics.
### FIGURE 3
Examples of High Yield Municipal Bonds with Disparate Credit Profiles

<table>
<thead>
<tr>
<th>Credit Name</th>
<th>When Issued</th>
<th>Background</th>
<th>Status</th>
<th>CNR Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>CommonSpirit Health</td>
<td>2019</td>
<td>A merger of Dignity Health and Catholic Health Initiatives that resulted in $5.5B debt restructuring under the new organization. BBB-tier ratings reflect expected cost savings, synergies, market reach, and management. CommonSpirit is now one of the largest NFP systems in the U.S. by revenue and operational footprint.</td>
<td>Not in Distress</td>
<td>Yes</td>
</tr>
<tr>
<td>MN College of Osteopathic Medicine</td>
<td>2019</td>
<td>Financed building renovations for the site of a new medical school that quickly deteriorated in quality as construction activity ceased shortly after breaking ground due to a combination of manager breach of escrow terms, permit delays and inability to achieve a board certification. There are insufficient funds on hand to meet a mandatory tender, and the manager is in discussions with Touro College to assume the project. BBB-tier at issue but downgraded to CC-tier within six months of issuance.</td>
<td>Distressed</td>
<td>No</td>
</tr>
<tr>
<td>Green Gables MET District</td>
<td>2016</td>
<td>A Denver-area residential development project slated for 300 Lennar-constructed homes that are nearly built-out (255 of 300 target homes received a certificate of occupancy). Assessed valuation and max mill tax on the property are now sufficient to cover maximum debt service. Speculative rating equivalent at issue improved to IG equivalent within three years.</td>
<td>Not in Distress</td>
<td>Yes</td>
</tr>
<tr>
<td>Ballston Quarter CDA</td>
<td>2016</td>
<td>A retail mall renovation and repositioning project in Arlington, VA, with less than 50% lease rate at the time the bonds were issued. The tax-exempt portion failed to provide bondholders a special backup assessment from the project developer (only on the taxable part) and relied upon incremental property and sales taxes, which were unable to support bond debt service. NR bonds drew upon reserves to make the September 2019 bond payment.</td>
<td>Distressed</td>
<td>No</td>
</tr>
</tbody>
</table>

Source: City National Rochdale as of 10/2019.

Results vary and those shown above may not be indicative of the performance of all current or future holdings of the fund.

MUNICIPAL TOP TEN HOLDINGS

- New Jersey St Transn Tr Fd Aut Trans Prog Bds 2019 a Trans 5.25 06/15/2043 1.24%
- Buckeye Ohio Tob Settlement Fi Tobacco Settlement Asset a-2 Tobacc - Turbo Sinking Fund 5.75 06/01/2034 1.02%
- North Tex Twy Auth Rev Sys First Tier Ref Bds 2019 a Sys Fi 5 01/01/2038 0.87%
- Colorado Health Facs Auth Rev Hosp Bds 2019 a Hosp B Conduit: Adventhealth Obligated Group 4 11/15/2038 0.80%
- Puerto Rico Sales Tax Fing Cor Restructured a-2 Restru - Cofina 4.329 07/01/2040 0.79%
- New York Liberty Dev Corp Libe Bds 2014 Bds Conduit: 3 World Trade Center Llc 5 11/15/2044 0.78%
- Pennsylvania St Tpk Commn Tpk Bds 2019 a Bds 4 12/01/2049 0.78%
- Puerto Rico Sales Tax Fing Cor Restructured a-2 Restru - Cofina 4.784 07/01/2058 0.77%
- Jefferson Cnty Ala Swr Rev Swr Rev Wts D Swr Re 6 10/01/2042 0.76%
- Chicago Ill GO Bds 2017 a GO Bds - Proj and Ref Bds 6 01/01/2038 0.76%

Percent in Top 10 Holdings 8.57%

Holdings are subject to change.
Index Definitions

Bloomberg Barclays High Yield Municipal Bond Index (barhiym) is an unmanaged index considered representative of non-investment-grade bonds.

Bloomberg Barclays Municipal Bond Index (lehmunlt) is a market-value-weighted index for the long-term tax-exempt bond market. To be included in the index, bonds must have a minimum credit rating of Baa. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least 1 year from their maturity date.

MMA defines [monetary] default as a full or partial missed payment of scheduled principal and/or interest to bondholders, even when bondholders agree to, or direct, non-payment.

An impairment is a catch-all term that includes monetary default and other types of events, such as draws on reserve funds or claims under a bond insurance policy to pay debt service, and covenant violations (i.e., failure to comply with terms or conditions of a bond agreement).

Important Disclosures

The information presented does not involve the rendering of personalized investment, financial, legal, or tax advice.

Certain statements contained herein may constitute projections, forecasts, and other forward-looking statements, which do not reflect actual results and are based primarily upon a hypothetical set of assumptions applied to certain historical financial information. Certain information has been provided by third-party sources, and, although believed to be reliable, it has not been independently verified, and its accuracy or completeness cannot be guaranteed.

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All investing is subject to risk, including the possible loss of the money you invest. As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money. Diversification does not ensure a profit or protect against a loss in a declining market. Past performance is no guarantee of future performance.

There are inherent risks with fixed income investing. These risks may include interest rate, call, credit, market, inflation, government policy, liquidity, or junk bond. When interest rates rise, bond prices fall. This risk is heightened with investments in longer duration fixed-income securities and during periods when prevailing interest rates are low or negative.

Investments in below-investment-grade debt securities which are usually called "high-yield" or "junk bonds," are typically in weaker financial health and such securities can be harder to value and sell and their prices can be more volatile than more highly rated securities. While these securities generally have higher rates of interest, they also involve greater risk of default than do securities of a higher-quality rating.

This material must be preceded or accompanied by a current summary or full prospectus. Investors should read it carefully before investing or sending money.

The yields and market values of municipal securities may be more affected by changes in tax rates and policies than similar income-bearing taxable securities. Certain investors' incomes may be subject to the Federal Alternative Minimum Tax (AMT) and taxable gains are also possible.

Investing involves risk including loss of principal. Bonds and bond funds are subject to interest rate risks and will decline in value as interest rates rise. Investing in securities that are not investment grade offers a higher yield but also carries a greater degree of risk of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments. No investment strategy can guarantee a profit or protect against loss in periods of declining values. There is no guarantee that the Fund's income will be exempt from federal or state income taxes. Capital gains, if any, are subject to capital gains tax. Income from municipal bonds may be subject to the alternative minimum tax.

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