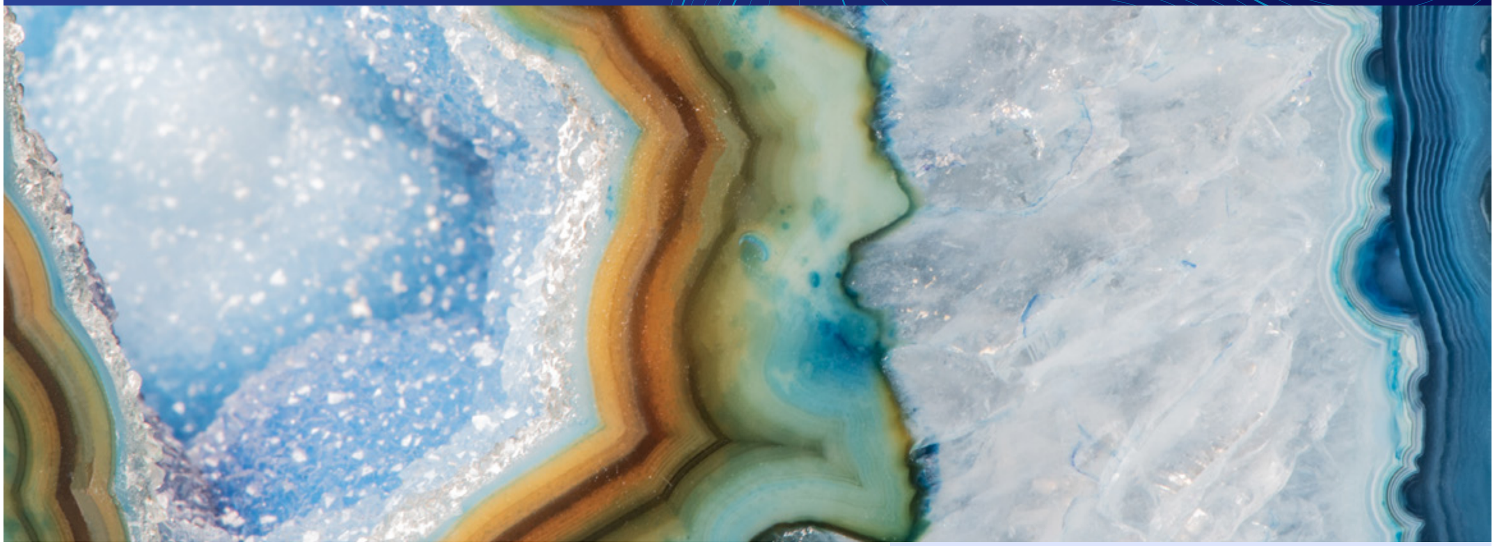

Breaking Ground in Search of Hidden Gems in the Muni Bond Market

After two years of declining net issuance and heavy investor outflows, the municipal bond market began to recover on both fronts in 2024, and we believe technical and fundamental dynamics may continue to be supportive of the asset class in 2025.

With federal support waning, revenue growth cooling and project costs rising, strong muni bond issuance should persist through this year, and we expect the attractive yields these bonds offer to bolster ongoing demand. Credit fundamentals remain well supported by strong fiscal positions at the state and local levels, and we think ongoing economic growth and labor-market strength is likely to keep tax revenues and fiscal dynamics healthy. Meanwhile, muni bond yields remain above their historical averages, presenting an attractive risk-reward scenario for a range of investors.

We believe the significant dispersion of yields and prices in the highly fragmented muni bond market provides active managers with ample opportunities to add marginal value. This is particularly true within the large, diverse cohort of unrated bonds. While these bonds have not been subject to the proprietary scrutiny of a nationally recognized statistical rating organization, we don't believe their lack of rating should be interpreted as a reflection of the borrower's capacity to meet its financial commitments. On the contrary, it is our view that unrated bonds represent a bountiful hunting ground where managers can leverage their credit underwriting skills to identify bonds that are undervalued relative to the overall market and offer attractive yields relative to their credit quality and default risk.

KEY TAKEAWAYS

- In our view, the favorable supply-demand dynamics that emerged last year may continue to support the muni bond market broadly in 2025. Meanwhile, muni bonds—and high yield muni bonds, in particular—continue to offer attractive yields on both an absolute and tax-equivalent basis.
- Persistent economic growth and labor-market strength in the US is likely to keep tax revenues and fiscal dynamics healthy, supporting credit fundamentals for municipal issuers.
- The significant dispersion of yields and prices in the highly fragmented municipal bond market offers managers ample opportunity to leverage their expertise in credit analysis and security selection to identify undervalued paper, particularly among unrated bonds.
- Unrated does not equal uninvestable, nor does it necessarily imply greater risk. Land-secured muni bonds (aka "dirt bonds") are an example of a type of municipal financing that is typically unrated at issuance but offers rich opportunities for active managers to identify bonds they believe are undervalued relative to their credit quality and default risk.

Supportive Muni Dynamics May Continue

As the Federal Reserve steadily raised its policy rate across 2022 and 2023 in the face of decades-high inflation, many state and local municipalities—their coffers generally well stocked thanks to Covid-era federal stimulus and a large post-Covid rebound in tax revenue—curtailed bond issuance in what was a volatile interest rate environment. As shown in Exhibit 1, annual issuance of new muni bonds during the two years of the rate-hike cycle was off about 20% from previous levels. With the Fed on hold and ultimately moving to cut rates in 2024, tax-exempt issuance bounced back to a record high last year, and we believe a healthy level of supply is likely to persist as the benefit of federal support wanes and interest rates continue to moderate.

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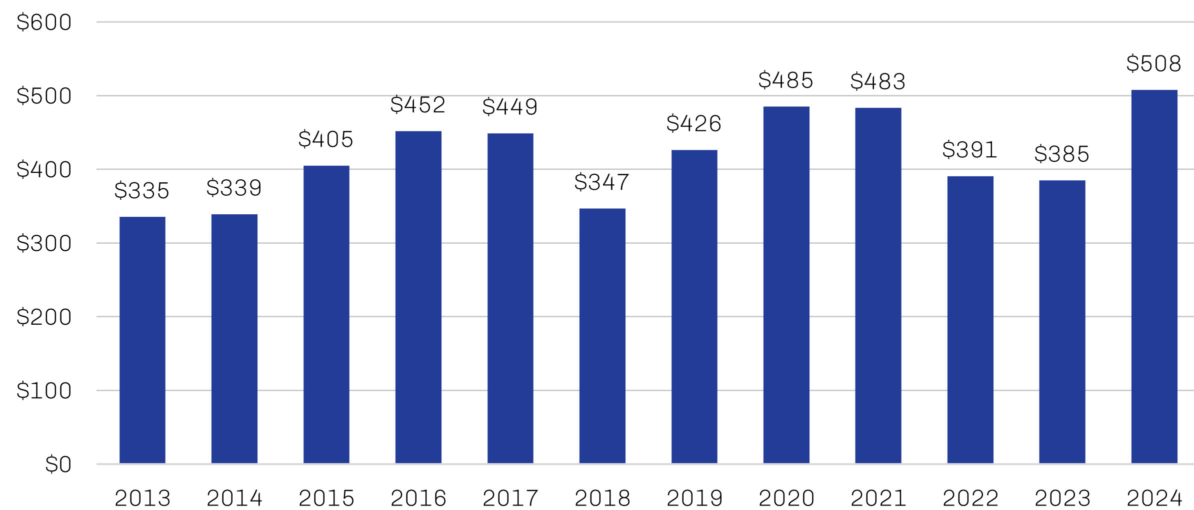
Exhibit 1. With Interest Rates off Their Peaks, Muni Bond Issuance Recovered in 2024

Annual Municipal Bond Issuance in Billions of US Dollars, 2013 through 2024



Source: Securities Industry and Financial Markets Association; data as of January 2, 2025.

Fed tightening also weighed on the demand side of the muni bond market, as higher yields on cash equivalents like money market funds lured investors away from other, riskier fixed income assets.[1] Investors began to move back into muni mutual funds and exchange-traded funds (ETFs) in 2024, but inflows to date remain far from recouping all of the outflows from 2022 and 2023.[2] In our view, the potential for lower interest rates in 2025 may provide durable support for inflows and help absorb renewed muni issuance.

Meanwhile, the fiscal positions of municipalities—unlike that of the US federal government—continue to be strong. The overall amount of municipal bond debt outstanding has not materially changed in the last 20 years; over the same period, total US corporate debt has doubled and federal debt has tripled.[3] Total financial assets for state and local governments are at an all-time nominal high, with notable strength in reserve funds, and expenditures have begun to moderate.[4] Ratings agencies maintain a positive bias toward muni bonds, as upgrades continue to outpace downgrades; moreover, most of the defaults we saw last year were idiosyncratic in nature.[5]

1. Source: Morningstar; data as of October 31, 2024.
2. Source: Investment Company Institute; data as of November 4, 2024.
3. Source: Securities Industry and Financial Markets Association; data as of January 2, 2025.
4. Source: Board of Governors of the Federal Reserve System, US Bureau of Economic Analysis, National Association of State Budget Officers; data as of November 30, 2024.
5. Source: Moody's Investors Service; data as of November 15, 2024.

We believe both technical and fundamental dynamics may continue to be supportive of municipal bonds in 2025. While munis declined in tandem with Treasuries immediately following the outcome of the US presidential election in November, the market reversed shortly thereafter.[6] There has been much rhetoric around potential policy impacts of Trump's victory, but specifics remain to be seen. An extension of the individual taxpayer provisions in 2017's Tax Cuts and Jobs Act seems likely given a unified Republican government, but narrow majorities in the House and Senate mean there are no guarantees. More importantly, ongoing economic growth and labor-market strength is likely to support robust tax revenues and healthy fiscal dynamics for municipalities, as well as high recovery rates in the event of bond defaults. Continued monetary easing—the latest projection from the Fed suggests an additional 50 basis points worth of cuts to the policy rate in 2025, which would bring it to a range of 3.75–4.00%—could provide additional support to muni bonds.[7]

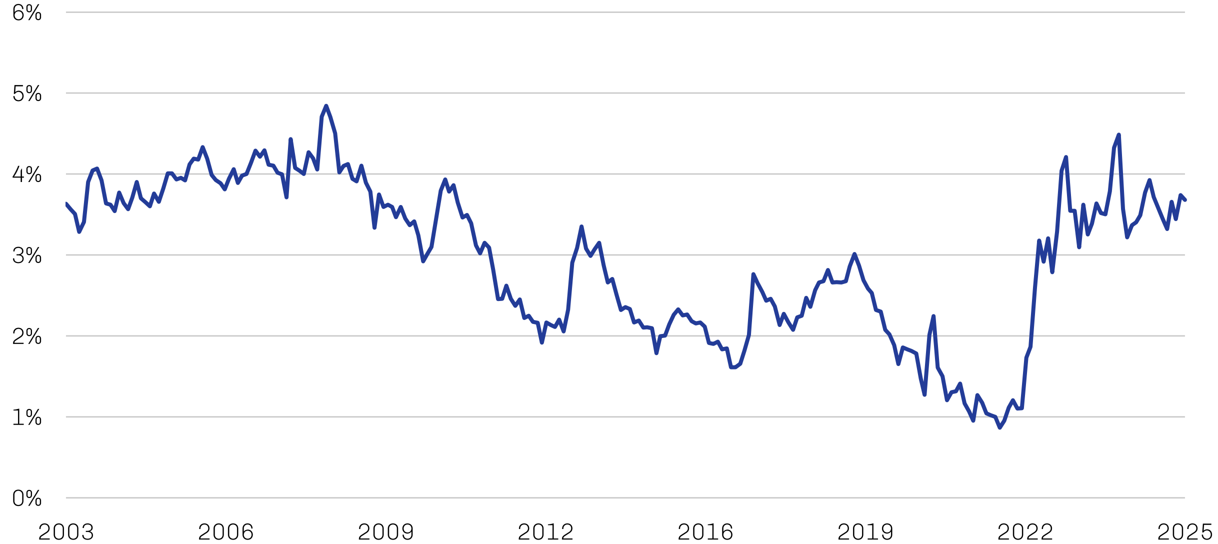
Ongoing economic growth and labor-market strength is likely to support robust tax revenues and healthy fiscal dynamics for municipalities.

Dispersion Brings Opportunity

Though it has pulled back alongside Treasuries, the muni bond market continues to offer investors yields above the historical average, as shown in Exhibit 2. Importantly, however, the fragmentation of the very large muni market results in significant dispersion of yields and prices for similar bonds, particularly lower in the credit-quality spectrum. This is most notable among those bonds not assigned a credit rating by a nationally recognized statistical rating organization (NRSRO)—i.e., unrated bonds. Exhibit 3 depicts the much wider range of yields and prices among unrated bonds within the S&P Municipal Yield Index compared to the AA/Aa2-rated cohort. In our view, this dispersion represents a bountiful hunting ground where active managers can leverage their credit underwriting skills to identify bonds that are undervalued relative to the overall market.

Exhibit 2. Muni Yields Remain Higher than the Historical Average at the Index Level...

Bloomberg Municipal Bond Index Yield to Worst, January 2003 through January 2025

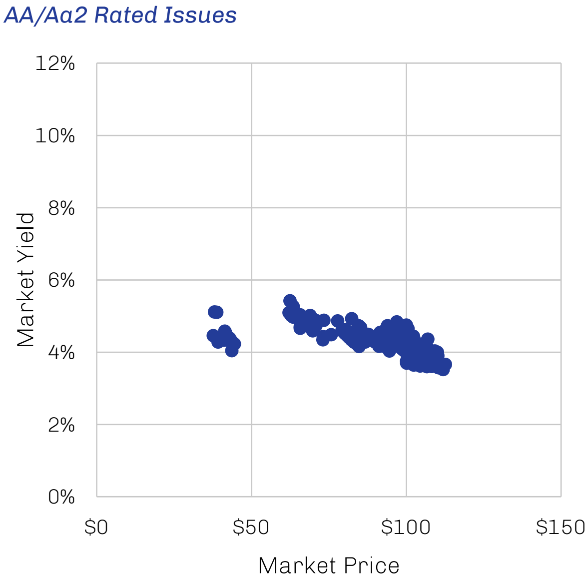


Note: Yield to worst is a financial metric that helps investors assess the minimum yield they can expect from a bond under various scenarios. It accounts for the bond's yield in the worst-case scenario, considering factors like call provisions, prepayments and other features that may affect the bond's cash flows.

Source: Bloomberg; data as of January 31, 2025.

6. Source: FactSet; data as of December 31, 2024.
7. Source: Federal Reserve; data as of December 18, 2024.

Exhibit 3. ...but Significant Price and Yield Dispersion Exists Among Individual Credits
Comparison of Bonds in the S&P Municipal Yield Index with 2044 Maturities



Source: Bloomberg; data as of January 31, 2025.

Unrated ≠ Uninvestable

The High Yield Municipal Credit team's investment philosophy often leads us to areas of our universe where we believe our expertise in credit analysis and security selection gives us an advantage. Unrated bonds—a segment that comprises approximately two-thirds of the S&P Municipal Bond High Yield Index based on number of issues—are a prominent example.[8]

While unrated bonds have not been subject to the proprietary scrutiny of the likes of Moody's or S&P Global Ratings, we don't believe their lack of rating should be interpreted as a reflection of the borrower's capacity to meet its financial commitments. There are a number of reasons a muni bond may go unrated at the time of issuance, the most straightforward of which is the cost. Issuers must pay a fee to the agency for its rating and also typically incur additional costs associated with preparing information for the agency; small offerings—which are not unusual in the muni space—may not find the expense of achieving a rating worthwhile relative to the proceeds raised.

> We don't believe a lack of rating should be interpreted as a reflection of the borrower's capacity to meet its financial commitments.

Though not necessarily riskier than any other muni bonds, the lack of rating lands not-rated bonds in the noninvestment grade bucket. To compensate for greater complexity and information risk involved with these bonds, they typically pay investors a higher yield compared to rated issuers of similar quality; as a result, skilled credit managers may find favorable yields relative to credit quality and default risk.

As an example, let's consider land-secured muni bonds—aka, "dirt bonds". Typically unrated, dirt bonds are issued by a public agency in partnership with a developer to finance infrastructure improvements such as roads, sidewalks and utilities for new residential communities. As the bonds' proceeds fund a capital improvement that provides a public benefit, they typically are issued tax exempt. They are secured by a tax lien assigned to the property that is commonly paid off over a 30-year term through an annual special assessment coequal with property taxes. Development projects can be risky, especially in the early stages, but dirt bonds typically offer

8. Source: S&P Global; data as of December 31, 2024.

yields that we believe more than compensate for these risks compared to other forms of municipal financing, along with structural features that further enhance their appeal.

As the performance of dirt bonds is dependent on the progression of the project being financed and ultimately its sale to end users once developed, underwriting these opportunities entails the analysis of a great number of factors. For example, we would look at the master developer's financial resources and ability to maintain the project through any potential downturns in the real estate market. We would assess the ratio of debt to equity for the project to determine the developer's skin in the game. From a top-down prospective, we evaluate local and national economic trends—such as job growth in the area and prevailing mortgage rates—that may impact the project's success. Finally, we would evaluate the structure of the deal, including any security features or credit enhancements built into the bond indentures.

As these projects progress and begin to generate revenue from a diversified tax base, the bonds may appreciate in price as the risk level recedes. Moreover, upon achieving certain development and revenue milestones, issuers may be able to refinance (or "refund" in muni parlance) the bonds, potentially at a lower interest rate and with an NRSRO rating.

Within this important high yield category, we currently focus much of our attention on Florida, Texas and Utah, where population growth is being fueled by low taxes, above-average job creation and better housing affordability. There continues to be a severe housing shortage across the US because of a structural undersupply of new construction following the global financial crisis. More than one million single-family homes need to be built every year to keep pace with the country's household formation, but commercial homebuilders are falling short.[9] The impact of new-home underbuilding has been exacerbated by the limited supply of existing homes for sale, as the "lock-in effect" of low mortgage rates has disincentivized homeowners from selling. This dynamic also has enabled homebuilders to take share from the resale market; new-home sales now account for more than 30% of all homes sold, double the pre-Covid rate.[10] With new housing developments selling quickly and taxpayers/revenue streams thus diversifying at a similar pace, the credit quality of many dirt bonds has improved.

> Not all speculative bonds are created equal, which highlights why the differentiated risk/reward profile of unrated bonds may offer opportunity.

This improved credit quality also illustrates that not all speculative bonds are created equal and highlights why the differentiated risk/reward profile of unrated bonds may offer opportunity. Further, high yield municipal bonds have a far lower historical default rate than comparable corporate issues. While a typical unsecured corporate bond is backed by nothing other than the issuer's creditworthiness and a contractual obligation to repay, municipal bonds generally include some sort of structural enhancement bolstering their risk profiles. General obligation bonds, for example, are backed by the full faith and credit of the issuing municipality, which includes its taxing power. Revenue bonds are linked to income streams generated by specific projects or public works, such as those generated by a toll road or hospital. All told, speculative-grade municipal bonds had an average trailing-12-month default rate of just under 1% for the period 1970 to 2022 compared to 4% for similarly rated corporates.[11]

9. Source: Freddie Mac; data as of May 15, 2024.
10. Source: US Census Bureau, US Department of Housing and Urban Development, National Association of Realtors; data as of November 26, 2024.
11. Source: Moody's Investors Service; data as of December 31, 2022.

Seeking Resilience in Fertile Ground

While we are constructive on the municipal market as a whole, our investment process takes us to unloved, overlooked or contrarian areas of the market where we believe fundamental, research-driven investment managers may be able to uncover particularly attractive opportunities. With about $4 trillion distributed across more than one million distinct municipal bonds and 50,000 issuers, the highly fragmented municipal bond market is subject to significant yield dispersion among its constituents, particularly those without ratings.[12] We believe this dispersion offers rigorous, fundamental credit managers an opportunity to source bonds whose yields and prices more than adequately compensate for the credit risk involved.

> We believe the dispersion of the highly fragmented bond market offers rigorous, fundamental credit managers an opportunity to source bonds whose yields and prices more than adequately compensate for the credit risk involved.

12. Source: Securities Industry and Financial Markets Association; data as of January 2, 2025.

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Past performance is not indicative of future results.

Risk Disclosures

All investments involve the risk of loss of principal.

Municipal bonds are subject to credit risk, interest rate risk, liquidity risk, and call risk. However, the obligations of some municipal issuers may not be enforceable through the exercise of traditional creditors' rights. The reorganization under federal bankruptcy laws of a municipal bond issuer may result in the bonds being cancelled without payment or repaid only in part, or in delays in collecting principal and interest.

The information is not intended to provide and should not be relied on for accounting or tax advice. Any tax information presented is not intended to constitute an analysis of all tax considerations.

Indexes are unmanaged and do not incur management fees or other operating expenses. One cannot invest directly in an index.

Bloomberg Municipal Bond Index (Gross/Total) measures the performance of the US municipal tax-exempt investment grade bond market. A total-return index tracks price changes and reinvestment of distribution income.

S&P Municipal Yield Index (Gross/Total) measures the performance of high yield and investment grade municipal bonds. A total-return index tracks price changes and reinvestment of distribution income.

S&P Municipal Bond High Yield Index (Gross/Total) measures the performance of bonds in the S&P Municipal Bond Index that are not rated or whose ratings are below investment grade. A total-return index tracks price changes and reinvestment of distribution income.

AA credit rating—as used by S&P Global Ratings and Fitch Ratings—is an investment grade rating on a bond considered to have a very strong capacity to meet its financial commitments. The equivalent rating from Moody's Investors Service is Aa.

A **credit rating** is an assessment provided by a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from AAA/Aaa (highest) to D/RD (lowest); ratings are subject to change without notice. Not Rated (NR) indicates that the debtor was not rated and should not be interpreted as indicating low quality.

Exchange-traded funds (ETFs) are listed investment vehicles that seek to provide exposure to a benchmark, index or actively managed strategy.

General obligation bonds are municipal securities in which payments are backed by the full faith and credit of the issuer and by extension its ability to tax its residents.

High yield municipal bonds are debt securities issued by states, cities, counties and other public entities that offer a higher rate of interest due to their perceived higher risk of default.

Money market funds are a type of mutual fund that invests in cash, cash equivalents and short-term high-quality debt.

Moody's Investors Service is a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from Aaa (highest) to RD (lowest); ratings are subject to change without notice.

Revenue bonds are municipal securities whose payments are not backed by government's taxing power but by revenues from a specific project or source, such as highway tolls or lease fees.

S&P Global Ratings is a nationally recognized statistical rating organization (NRSRO) of credit worthiness of an issuer with respect to debt obligations, including specific securities, money market instruments, or other bonds. Ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest); ratings are subject to change without notice.

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