MainStay MacKay California Tax Free Opportunities Fund Class I MCOIX

Analysis

A California fund with some extra levers to pull.
By Alaina Bompiedi 9/27/2018

Some unique features have helped MainStay California Tax Free Opportunities take advantage of a supportive period for risky munis, leading to standout returns since the fund's 2013 inception. A solid team and affordable price tag support a Morningstar Analyst Rating of Bronze.

Co-CIOs John Loffredo and Bob DiMella oversee a collaborative group of four portfolio managers, a team they assembled after arriving at MainStay in 2009. But this team's history predates that, as many of its members worked alongside Loffredo and DiMella at Merrill Lynch Investment Management in the 1990s. This fund's lead manager is Scott Sprauer. He's helped by comanager Mike Petty, who allocates the fund's high-yield muni sleeve. They take a valuation-driven approach to credit selection yet are partly influenced by the group's broader macro and thematic views, which the team establishes at the beginning of each year.

Their intrepid approach is evidenced by a willingness to take uncommon positions, such as shorting 10-year Treasury futures to offset the duration of large purchases of long-dated munis, and buying insurance-wrapped distressed Puerto Rico paper. As interest rates have continued to hover around historical lows, the team has also made use of its flexibility to invest in high-yield munis up to a maximum of 20%.

That relatively aggressive tack has generated impressive performance so far. Since the fund's 2013 inception through August 2018, its 4.3% annualized return outpaced 89% of its peers in the muni California long Morningstar Category and beat its Bloomberg Barclays Municipal California Index benchmark by more than a percentage point. Still, a large high-yield position has hurt during muni sell-offs, as in August through December 2016, when the fund lost a touch more than the typical peer (4.8% versus the category's 4.6%). The fund's aggressiveness is also visible in its since-inception standard deviation, which was the third-highest in its peer group as of August 2018. While below-average fees make the fund a tantalizing option, its bold approach may not be appropriate for investors seeking safety.

Process Pillar: Positive

This team plies the same valuation-driven approach here as at MainStay MacKay Tax Free Bond MTBAX and MainStay MacKay High Yield Muni MMHAX, but adjusted for its smaller universe of California and territory munis. Unlike more-staid peers, this fund has the flexibility to invest up to 20% in high-yield munis, hold closed-end funds, and utilize Treasury futures. So far, this team has shown to be thoughtful in how it uses these tools across its lineup, earning the fund a Positive Process Pillar rating.

This group's distinctive tactical approach to muni management influences the fund's positioning, but the restricted universe of California and territory bonds creates some limitations. The team relies on bottom-up credit selection and valuation-driven trading to do most of the heavy lifting here, while its macro views inform emphases on credit quality and maturity tenor. While Sprauer doesn't make interest-rate bets and tends to keep the fund's duration in line with that of the Bloomberg Barclays California Municipal Bond Index, he has taken high-conviction positions in long-maturity bonds and hedged their duration with short positions in 10-year Treasury futures. That ability plus a maximum 20% high-yield muni position gives the fund more macro levers than others can pull, though they also add risk to the portfolio.

Funds with the freedom to invest in below-investment-grade debt have been prolific buyers of these bonds since 2013, as lower-quality munis have offered additional spread and less interest-rate sensitivity than their higher-quality counterparts. As of July 31, 2018, that preference was clear in this portfolio, which held 9% in below-investment-

Morningstar's Take

Morningstar Analyst Rating: Bronze

Morningstar Pillars

Process	Positive
Performance	Positive
People	Positive
Parent	Neutral
Price	Positive

Morningstar Analyst Rating

Morningstar evaluates mutual funds based on five key pillars, which its analysts believe lead to funds that are more likely to outperform over the long term on a risk-adjusted basis.

Analyst Rating Spectrum

Gold Silver Bronze Neutral Negative

Fund Performance

	Total Return %	+/- Category
YTD	0.39	-0.13
2018	1.95	1.32
2017	6.75	0.84
2016	1.07	1.00
2015	5.81	2.09

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grade securities alongside and including some atypical positions, such as an 11% short Treasury futures hedge and a 14% territory stake. That hedge allowed the fund to hold more long-maturity bonds while keeping its duration close to that of the benchmark. Because the fund's territory stake was mostly wrapped by insurance, the team viewed this as a conservative way of getting additional yield in the portfolio from exposure to riskier underlying credits.

As of July 2018, the fund's BBB-and-below position was nearly 25%, well beyond the range of its benchmark's 6%, and the category's 18%. That position contained a mix of tobacco bonds, charter schools, tax revenue, and territory debt. At the end of July 2018, the fund's total territory position contained a mix of investment-grade insured bonds and below-investment-grade insured and uninsured credits from Puerto Rico (6%), Guam (2.2%), and the Virgin Islands (2.4%).

Performance Pillar: Positive

From its 2013 inception through August 2018, the fund's returns have ranked in the best quintile of the muni California long category and beat the Bloomberg Barclays Municipal California Index by a percentage point annualized. That strong track record earns a Performance Pillar rating of Positive.

The fund has mainly benefited from a favorable environment for credit risk in the muni market over the past five years. Although its volatility has landed near the high end of its peer group, the fund's Sharpe ratio (a volatility-adjusted return measure) still outperformed the majority of its peers. The fund had an auspicious beginning: It got its start during 2013's muni sell-off, enabling it to load up on longer-maturity and lower-quality bonds that offered generous yields. That positioning hurt the fund's initial performance when yields continued to rise (the fund underperformed nearly all of its peers in 2013) but proved to be advantageous when the market rebounded in 2014 and the four years since, as municipal bond yields have moved closer in line with Treasury yields.

The rosy past five years have made it easy to forget the losses high-yield munis faced in 2008 (the handful of high-yield-heavy California long funds lost about 26% that year). While this fund can hold only up to 20% in these bonds, that can still be enough to bite in an extended sell-off.

People Pillar: Positive

A six-manager team keeps this fund on track. Co-CIOs John Loffredo and Bob DiMella orchestrate the effort, aided by four additional portfolio managers: Scott Sprauer, who acts as primary lead here; Mike Petty, who oversees high yield; David Dowden; and Frances Lewis. All the managers share a common history at MLIM, where they worked in the early 1990s. Loffredo and DiMella left MLIM shortly after its acquisition by BlackRock in 2006 and started their own firm, Mariner Municipal Managers LLC, which they ran before joining MacKay Shields in 2009. This team's long working relationship merits a People Pillar rating of Positive.

Sprauer provides most of the fund's oversight and portfolio management and is supported by Mike Petty, who manages the fund's high-yield sleeve. Prior to joining MainStay, Sprauer led the trading desk at Financial Guaranty Insurance Company and traded at Dreyfus and MLIM, while Petty was a senior high-yield muni portfolio manager at Dreyfus. Both managers act as leads on other funds in the MainStay muni lineup, Sprauer on Tax-Advantaged Short-Term Bond MSTIX, and Petty on High Yield Municipal Bond MMHIX and New York Tax Free Opportunities MNOIX. They are supported by a team of comanagers, a four-person analyst bench, trader John Lawler, and risk analyst Joanna Ng.

Parent Pillar: Neutral

MainStay is the retail investment brand of New York Life Investment Management, itself the asset-management arm of insurance company New York Life. MainStay's expansive mutual fund lineup is managed by NYLIM's investment professionals and subsidiaries, including fixed-income specialist MacKay Shields, global equity shop Candriam, Australian equity group Ausbil, and more recently, U.S. exchange-traded fund specialist IndexIQ. NYLIM also uses subadvisors, such as Epoch and Winslow, the latter of which runs MainStay's largest offering, MainStay Large Cap Growth. NYLIM has grown mostly through acquisitions and distribution partnerships.

NYLIM's boutiques tout that the parent allows them to operate with autonomy. In 2017, MacKay Shields Municipal Managers--one of the stronger boutiques under the NYLIM umbrella--was able to open a second office in Los Angeles to serve its growing base of California clients.

Yet, NYLIM's track record as a parent has some blemishes. The firm acquired long-short equity manager Marketfield in 2012, whose flagship fund, MainStay Marketfield, swelled to over $20 billion in assets by 2014, partly because of a strong sales push from MainStay. Asset bloat impeded performance, and the firms ended their relationship in early 2016. And while NYLIM grants its boutiques some independence, it merged Cornerstone into MacKay Shields in 2018. Overall, MainStay earns a Neutral Parent rating.

Price Pillar: Positive

Below-average fees earn the fund a Price Pillar rating of Positive.

Most of this fund's assets are held in its A and I share classes, which have fees lower than the averages of their respective distribution groups. Excluding certain investment-related costs, the A share class comes with a 75-basis-point net expense ratio, and the I shares are offered at 50 basis points. The fund's C shares charge 104 basis points; while this is high in absolute terms, it similarly ranks below that of other level-load muni long funds.

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MainStay MacKay California Tax Free Opportunities Fund — Class A and Class I Shares

Standardized Performance (Period ended 12/31/18)

Symbol (Inception)	1 year	3 years	5 years	Since Inception[1]
Class A (NAV) MSCAX (2/28/13)	1.79%	2.97%	5.81%	3.83%
Class A (max 4.5% load) MSCAX (2/28/13)	-2.79	1.40	4.84	3.01
Class I (no load) MCOIX (2/28/13)	1.95	3.23	6.08	4.09

Total annual operating expenses are: Class A: 0.82% and Class I: 0.57%. Net annual operating expenses are: Class A: 0.75% and Class I: 0.50%.

Returns represent past performance which is no guarantee of future results. Current performance may be lower or higher. Investment return and principal value will fluctuate, and shares, when redeemed, may be worth more or less than their original cost. Performance reflects a contractual fee waiver and/or expense limitation and management fee waiver agreements in effect through 2/28/19, without which total returns may have been lower. These agreements renew automatically for one-year terms unless written notice is provided prior to the start of the next term or upon approval of the Board. Visit mainstayinvestments.com for the most recent month end performance.

The Bloomberg Barclays California Municipal Bond Index is a market-weighted index of California investment-grade, tax-exempt, fixed-rate municipal bonds with maturities of one year or more. An investment cannot be made directly into an index. Past performance is no guarantee of future results.

Credit Ratings: S&P rates borrowers on a scale from AAA to D. AAA through BBB represent investment grade, while BB through D represent non-investment grade.

Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates.

The Morningstar Analyst Rating™ is not a credit or risk rating. It is a subjective evaluation performed by Morningstar's manager research group, which consists of various Morningstar, Inc. subsidiaries ("Manager Research Group"). In the United States, that subsidiary is Morningstar Research Services LLC, which is registered with and governed by the U.S. Securities and Exchange Commission. The Manager Research Group evaluates funds based on five key pillars, which are process, performance, people, parent, and price. The Manager Research Group uses this five pillar evaluation to determine how they believe funds are likely to perform relative to a benchmark, or in the case of exchange-traded funds and index mutual funds, a relevant peer group, over the long term on a risk-adjusted basis. They consider quantitative and qualitative factors in their research, and the weight of each pillar may vary. The Analyst Rating scale is Gold, Silver, Bronze, Neutral, and Negative. A Morningstar Analyst Rating of Gold, Silver, or Bronze reflects the Manager Research Group's conviction in a fund's prospects for outperformance. Analyst Ratings ultimately reflect the Manager Research Group's overall assessment, are overseen by an Analyst Rating Committee, and are continuously monitored and reevaluated at least every 14 months. For more detailed information about Morningstar's Analyst Rating, including its methodology, please go to global.morningstar.com/managerdisclosures/.

The Morningstar Analyst Rating (i) should not be used as the sole basis in evaluating a fund, (ii) involves unknown risks and uncertainties which may cause Analyst expectations not to occur or to differ significantly from what they expected, and (iii) should not be considered an offer or solicitation to buy or sell the fund.

Morningstar Analyst Rating Spectrum: *Gold:* Best-of-breed fund that distinguishes itself across the five pillars and has garnered the analysts' highest level of conviction. *Silver:* Fund with notable advantages across several, but perhaps not all, of the five pillars—strengths that give the analysts a high level of conviction. *Bronze:* Fund with advantages that outweigh the disadvantages across the five pillars and with sufficient level of analyst conviction to warrant a positive rating. *Neutral:* Fund that isn't likely to deliver standout returns but also isn't likely to significantly underperform, according to the analysts. *Negative:* Fund that has at least one flaw likely to significantly hamper future performance and that is considered by analysts an inferior offering to its peers.

Before You Invest:

Before considering an investment in the Fund, you should understand that you could lose money.

Municipal bond risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities.

A portion of the Fund's income may be subject to state and local taxes or the alternative minimum tax. Income from municipal bonds held by the Fund could be declared taxable because of unfavorable changes in tax law, adverse interpretations by the Internal Revenue Service or state tax authorities, or noncompliant conduct of a bond issuer. High-yield municipal bonds may be subject to increased liquidity risk as compared to other high-yield debt securities. The Fund may invest in derivatives, which may increase the volatility of the Fund's NAV. Funds that invest in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner.

Because the Fund invests primarily in municipal bonds issued by or on behalf of the State of California and its political subdivisions, agencies, and instrumentalities, events in California are likely to affect the Fund's investments and performance. These events may include fiscal or political policy changes, tax base erosion, and state constitutional limits on tax increases, budget deficits, and other financial difficulties. California may experience financial difficulties due to the economic environment. Any deterioration of California's fiscal situation and economic situation of its municipalities could cause greater volatility and increase the risk of investing in California.

1. Average annual total returns include the change in share price and reinvestment of dividends and capital gain distributions. Class I shares are generally only available to corporate and institutional investors.

For more information about MainStay Funds®, call 800-624-6782 for a prospectus or summary prospectus. Investors are asked to consider the investment objectives, risks, and charges and expenses of the investment carefully before investing. The prospectus or summary prospectus contains this and other information about the investment company. Please read the prospectus or summary prospectus carefully before investing.

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