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Investing in munis when risk isn't paying well

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Avoiding municipal credit risk completely may not be the answer.

The spread in municipal bonds — or the amount investors are rewarded for investing in bonds with more credit risk — is approaching record lows, but there are good fundamental and technical reasons that explain this shift. These conditions may remain in place for a while, so investors can't sacrifice yield by avoiding the bonds completely.

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Why is municipal bond risk not paying well?

One of the most basic fixed-income principles states that increases in demand result in higher prices. Corporate tax rate reform at the end of 2017 lessened demand from banks and insurance companies, but personal tax rates remain largely unchanged in higher income brackets so demand from individuals has been steady. This year has also seen a record amount of maturing bonds and coupon payments in 2018, giving individual investors plenty of cash to reinvest in what remains a very tax-efficient option. At the same time, supply of municipal bonds has been reduced due to tax code changes that eliminated the ability of issuers to advance refund their debt.

Coinciding with increased demand, strong economic growth has led to widespread stability. Tax revenues have exceeded expectations in many states, and their rainy-day reserve funds continue to grow. The number of defaults in the municipal market have declined every year since peaking in 2010. And 2018 is on track for one of the lowest levels of municipal defaults on record.

The effect is more pronounced in lower quality municipal bonds.

Knowing all of this, it should come as no surprise that municipal bond spreads are approaching record lows:

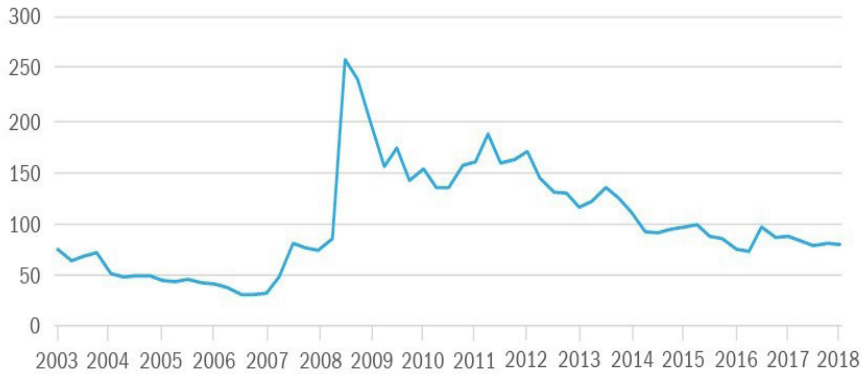
- As recently as 10 years ago, California general obligation bonds were trading at higher spreads than many speculative bonds because there was a lot of uncertainty around California's fiscal health and ability to repay the bonds. Now, California bonds are trading at lower yields than AAA-rated bonds due to strong demand for tax-exempt bonds in a high-tax state such as California.

- Municipal bonds that are issued to fund specific projects are easily finding investors despite sometimes involving risky retail development, untested technology or high degrees of construction risk. What's more, even the riskier deals are often being repriced to lower yields after they're issued due to strong demand.
- Some municipal bonds in higher-yielding sectors, such as health care, are weakening security pledges (which give bondholders certain remedies if a credit becomes distressed) and removing reserve funds (which would be used to repay bondholders). Yields have continued to decline for many of these issuers despite weaker bondholder protections.

These are just a few examples. Overall, the reward for investing in riskier bonds is approaching the record lows of 2006.

Difference in yield between high-quality and riskier municipal bonds is declining

Credit spread between Aaa-rated and Baa-rated municipal bonds, in basis points



06/2003–06/2018

Source: Thomson Reuters as of 06/2018.

There's a case for staying invested.

Even though municipal bonds are rewarding investors less for taking risk (compared to historical averages), municipal bond yields are still compelling (compared to other fixed-income alternatives). As of August 2018, the Bloomberg Barclays Corporate Investment Grade Index was yielding 3.95%, and the tax-equivalent yield for an investor with a 40.8% tax rate in the Bloomberg Barclays Municipal Bond Index was 4.53%.[1]

Investing in this market requires a different approach. We believe current market conditions are an opportunity to sell bonds that may have limited upside and to remain invested in lower-quality bonds that offer attractive yields. This strategy requires the help of sufficient credit research resources because it's more important than ever to understand the risks involved and analyze how a project may fare in less-than-ideal economic circumstances. While a recession may not be around the corner, a downturn at some point is inevitable and must be factored into analyzing future cash flows.

Bottom line

Although investors are being rewarded less for taking risk than they were in the

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recent past, there are solid fundamental and technical reasons behind the trend. These conditions may remain in place for an extended period of time, so investors can't afford to sacrifice yield by completely avoiding credit risk. Instead, consider seeking an active municipal bond manager to sell bonds with a limited upside, and identify riskier bonds that are appropriately compensating for the risk.

[1]Assumes a 2018 federal income tax rate of 40.8% (37.0% income tax rate + 3.8% net investment income tax rate). Other taxes are possible. State income taxes may be applicable and can further reduce the after-tax returns of some municipal bond investments (depending on the state of residence). Income from certain tax-exempt securities may be subject to the federal and/or state alternative minimum tax for some investors. In addition, federal and state income tax rules will apply to any capital gain distributions and capital gains or losses on sales. When investing in municipal securities, investors in higher tax brackets can receive a greater tax benefit than those in lower tax brackets. Municipal bonds provide income exempt from federal and, in some cases, state income taxes. **Past performance does not guarantee future results.**

There are risks associated with fixed-income investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities. Income from tax-exempt municipal bonds or municipal bond funds may be subject to state and local taxes, and a portion of income may be subject to the federal and/or state alternative minimum tax for certain investors. Federal income tax rules will apply to any capital gains.

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