Bond Case Briefs

Municipal Finance Law Since 1971

WSJ: Should You Buy Taxable Muni Bonds?

What do you get when you throw out the chief reason investors buy municipal bonds—their tax-free status?

Apparently, a truckload of buyers.

This year through Monday, issuers have originated $19.6 billion in taxable municipal bonds, nearly double the amount of the same period a year ago, according to investment researcher Municipal Market Advisors.

Taxable munis, unlike their tax-exempt cousins, aren't shielded from federal, state or local taxes.

Some investors still might find the bonds worth a look. But most small investors should be wary.

Despite the lack of tax benefits, issuers have found no shortage of buyers. The bonds are popular among institutional investors and mutual funds that can't take advantage of tax breaks. One example: The Build America Bonds program, through which state and local governments issued $181 billion worth of bonds before its expiration in December 2010.

Nowadays, the chief issuers are organizations that want to use the money for purposes that aren't permitted with tax-exempt bonds, such as to bolster an underfunded pension plan.

Some organizations also have issued the bonds to refinance their debt. Harvard University, for example, issued about $402 million in taxable muni bonds in May.

But in their persistent search for income, some small investors are grabbing the bonds, too, says Jim Colby, senior municipal strategist at Van Eck Global, which manages five tax-exempt municipal-bond exchange-traded funds.

"I don't doubt for a moment that some of these bonds are finding their way into individual accounts," Mr. Colby says.

In the past 12 months, for example, about $107 million has poured into the $1.1 billion PowerShares Build America Bond BAB -0.33% ETF, one of the biggest taxable-muni-bond ETFs, according to investment researcher IndexUniverse.

So what is the problem, you ask?

For starters, though the bonds typically have a higher yield than their tax-exempt peers, this year that premium has fallen sharply.

Just a year ago, the spread between the yield of a typical tax-exempt municipal bond and that of a taxable one was about one percentage point, says Matt Fabian, managing director of Municipal Market Advisors. Now, that premium can be as small as half a percentage point.

That means, at least for taxable accounts, small investors will be hard-pressed to find a taxable muni that leaves them with more money than a tax-exempt alternative.

For example, someone in the 39.6% federal tax bracket who could earn 3% with a tax-exempt bond would need to find a taxable bond yielding nearly 5% to make the switch worth it, before factoring in state or local taxes or the 3.8% investment surtax.

Second, funds—the easiest avenue for investors to get exposure to the taxable-muni market—have very long average maturities, which makes them vulnerable to interest-rate changes.

The PowerShares ETF, for example, has a yield of 4% and costs 0.28% annually, or $28 per $10,000 invested. The SPDR Nuveen Barclays Build America Bond ETF BABS -0.15% yields 4% with a 0.35% expense ratio, or $35 per $10,000 invested.

To estimate how a one-percentage-point rise in rates would hurt bond prices, investors calculate a measure called "duration." A fund with a duration of two years, for example, would lose 2% if interest rates rose by one percentage point immediately.

Both Build America Bond ETFs have a duration of more than 10 years, meaning that their values will drop by more than 10% if interest rates rise one percentage point.

"It's too risky. You only get a 4% yield for a lot of interest-rate risk," says Timothy Strauts, an ETF analyst at investment researcher Morningstar.

To be sure, in some specific cases, taxable munis could still make sense.

For one thing, tax-exempt munis don't have an edge in tax-advantaged vehicles, like individual retirement accounts. Inside an IRA, income is already tax-deferred.

And next to high-grade, long-term corporate bonds, taxable-munis—which many regard as safer investments—look like a deal.

For example, the yield of the PowerShares ETF is only slightly below that of the Vanguard Long-Term Corporate Bond ETF, which yields 4.5% and has a longer duration.

Finally, President Barack Obama's latest budget proposal calls for a cap on the amount of muni income exempt from federal taxes for some high earners, which if passed would lessen the advantage of tax-exempt munis.

Taxable munis can sometimes look like a relative value compared with other bonds. But that just reflects the fact that all bonds, no matter what slice you take, are high priced, Mr. Strauts says. If and when rates rise, long-term bonds of all stripes will suffer, he says.

As with all parables, the Great Bond Bubble eventually will end with a memorable lesson. Here's hoping you will read about it in the papers rather than in a portfolio statement.