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Why Foreigners Keep Buying the Debt of America's Small Towns.

Foreign investment in municipal bonds has doubled since 2009

America's asset managers are finding new ways to take advantage of the latest trend: the wave of foreign investors buying the debt of U.S. cities and states.

Overseas dollars have been flooding into the municipal market for several years, with foreign investment in munis doubling since 2009 to $106 billion of the $3.8 trillion market, according to Federal Reserve data. The trend picked up in the last quarter of 2016, with foreign investors adding an unprecedented $21 billion in municipal bonds.

Foreign companies see no benefit from the tax-exemption that comes with most muni bonds, so they tend to gravitate to higher-yielding taxable bonds. But some foreign investors are also interested in tax-exempt bonds, testing an assumption of the muni market, that buyers typically are drawn in part by tax advantages.

Attempting to meet the surge in demand, Nuveen Asset Management and a subsidiary of Citigroup Inc. C -0.77% will soon launch a mutual-fund type municipal-bond investment vehicle. The fund will be managed by Nuveen, according to people familiar with the matter.

Other money-management firms are wooing banks and insurance companies in Taiwan, Korea and Japan by offering private municipal-bond funds. Another firm is selling shares in exchange-traded funds to Swiss and British investors.

"Munis are global now," said Rob Amodeo, head of municipals at Western Asset Management, a Pasadena, Calif.-based bond manager that is a subsidiary of Legg Mason .

Since November 2015, Western Asset has run a private fund that invests in municipal debt on behalf of Japanese financial institutions in partnership with Japan's Shinsei Bank Ltd.

Standish Mellon Asset Management LLC, a unit of Bank of New York Mellon , recently won a commitment from a Korean insurance company to run a separately managed account filled entirely with municipal bonds, senior portfolio manager Jeffrey B. Burger said. The firm is in talks with other insurers in Korea, China and Japan as well as an investor in Australia, he said.

The typical overseas investors in municipal debt are foreign life insurers in search of long-dated securities to match their long-term liabilities, bankers and asset managers said. Banks have also made up a substantial portion of the demand.

The trend means these overseas investors are often buying the debt of towns they couldn't find on a map. At Nuveen Asset Management, which already manages the municipal-bond investments of some Asian and European institutions, "We've brought an atlas into meetings before," said co-head of global fixed income John Miller.

These investors are tempted by the bonds' relative safety, longer duration and relative yield. Some are also seeking diversification. A strengthening dollar—which the Federal Reserve could promote by raising short-term interest rates—could also help bolster the investments.

There are risks, given the bonds often won't mature for decades and rising long-term rates could reduce their value. Municipal bonds aren't as liquid as Treasurys. In addition, U.S. municipalities have, on rare occasions, defaulted.

Even so, several factors continue to tempt buyers.

At asset manager VanEck, about 8% of its $1.8 billion municipal high-yield ETF is foreign investment, up from 3% one year ago.

"Muni high yield has compared very favorably across the globe," said senior municipal strategist Jim Colby.

The majority of the international investment in the VanEck ETF—$116 million—comes from Taiwan. Investors in Canada, Switzerland and the United Kingdom each hold more than $5 million. These investors have bought in despite the fact that the bonds in the VanEck ETF carry a tax-exemption that doesn't benefit foreign investors.

More typically, foreign investors gravitate to higher-yielding taxable bonds, of which there are about $450 billion outstanding, according to Barclays. The S&P Taxable Municipal Bond Index returned 1.72% in the past year, compared with a negative-2.05% return for the S&P U.S. Treasury Bond 7-t--10 year Index and a negative 0.75% for the S&P Global Developed Sovereign Bond Index.

The heightened demand is a likely contributor to increased market activity.

Trading in taxable municipals has shown a steady climb in activity since 2014, according to an analysis of Municipal Securities Rulemaking Board data by Natalie Cohen, head of municipal research at Wells Fargo Securities.

The new market players are also changing the work life of professionals accustomed to a quiet and slow-moving domestic market. Mr. Burger, the Standish portfolio manager, hadn't visited Asia once in his 41 years before October. He has now been to Beijing, Hong Kong, Seoul and Tokyo.

"If you were to ask me even in early summer of last year would I ever expect that this career would change to where I am now about to embark on my fourth trip to Asia in six months," he said, "the answer would have been 'no.'"

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