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What Advisors Should Know About Muni Bonds for 2022.

With tax season on the horizon, munis are on the mind. Municipal bonds, which are utilized to fund government activities and special projects, are generally free from federal taxes for their shareholders. They have become an important tax planning tool, which heightens their importance as tax season looms.

Recently, ETF Trends' managing editor Lara Crigger sat down with Joseph Gotelli, vice president and senior portfolio manager for American Century Investments, to discuss the role that muni bonds can play in a diversified, income-generating portfolio. Gotelli joined American Century in 2008, after seven years at Franklin Templeton Investments, where he served as assistant portfolio manager on various long- and short-term municipal bond portfolios.

Lara Crigger, managing editor, ETF Trends: We've seen massive flows entering the muni bond space this year. What market conditions have made munis such an attractive option?

Joe Gotelli, vice president and senior portfolio manager, American Century Investments: Year to date, the asset class has had a very strong run. That was predominantly front-loaded at the beginning of the year, on the tail of the direct aid state and local governments received in mid-March under the American Recovery Plan Act (ARPA). That put a strong backstop into the fundamental view of the municipal credit market.

Additionally, the continuing recovery of the economy along with strong revenues at the state and local level really provided a tailwind for credit spreads early in the year. Combine that with expectations for large spending plans out of Washington and the potential for higher income taxes and corporate taxes, it helped to put tax mitigation on investors' minds. The attractive taxable equivalent yields the municipal market offers, combined with low default rates and low correlations to other asset classes, make a good case for owning municipals.

Then, as we look forward to 2022, we're probably looking at a more difficult rate environment. Rates have moved up recently, so total returns have come off the asset classes. A negative total return environment has created a little bit of a headwind for inflows into muni bonds. Investors have a more cautiously optimistic outlook for the fourth quarter and beyond. Still, there's lots of reasons to love the tax-exempt asset class as a whole.

Crigger: But there's still the expectation among investors of higher taxes down the line. Has that expectation evolved any, with all the back-and-forth in Congress?

Gotelli: Earlier in the year, investors were pricing in a higher probability of more extreme tax moves, in terms of what was proposed originally by the Biden administration. A lot of that has been taken back as the negotiations have continued. You've seen that in the ratio between municipals and treasuries. Mid-June is when we reached a recent peak in richness of the asset class, and since then, you've seen the relative value between munis and Treasuries ease off to become a more normalized range in the short term, but still generally rich over the long history of these ratios.

I do think investors recognize that it's probably not going to be [a situation] where short term capital gains skyrocket, and that, really, it's going to be on the margin for those earning $400,000 or more. The corporate tax rate is probably only going to go to something like 25–26%. The most extreme scenario was taken off the table.

Investors are focused on owning the right sectors within the municipal market now, underwriting the names that you want to own for the long term. Because much of that credit spread compression — where the asset class earned a lot of the return — is in the rearview mirror for us.

Crigger: What are the right sectors within the municipal market, then? Many strategies take a holistic approach to the market, rather than sector-specific.

Gotelli: The market is predominantly high quality, which speaks to the low historical default rate and the strong fundamentals. But this market is much more than just state and local general obligation bonds. You have a number of sectors on the revenue side that provide investors with incremental yield opportunities, if they can access those sectors in the marketplace. Broadly speaking, the market is about one third general obligation bonds and two thirds revenue bonds.

A huge portion of the market is made of revenue-centric projects: things like education, healthcare, transportation, revenue, utilities, essential services. Given how diverse the muni market is — we have over 50,000 issuers and hundreds of thousands of individual CUSIPs — we have to select using fundamental research that our research team provides us to find those incremental yield opportunities for investors. They might be in sectors like housing, healthcare, even some quasi-corporate style municipal credits. Those are the areas of the market where we'll capitalize on the relative value between sectors and leverage our research staff to do that deep fundamental analysis and provide the investment opportunities that might not be available in a more passive context.

Crigger: What other advantages does active management provide in the municipal bond market, compared to a market cap-based approach?

Gotelli: As we move away from market cap-weighted benchmarks, that provides us with a lens to view the market in terms of more relative value, and what's more opportunistic to the end investor. For the passive market participant, sectors such as healthcare, tobacco settlement, certain corporate names might not even be in the consideration set. So active management allows us to take them into the consideration set and view the entire market as an opportunity, rather than just the issuers that have issued the most amount of debt in the marketplace.

I think one thing that I always come back to is, when we talk with our credit team, we think about the fact that an AA-rated hospital is not the same as an AA-rated water bond, which is not the same thing as an AA-rated airport. They're all high quality, but with different risks. As you move down the credit spectrum, those differences get broader and broader in terms of what the credit quality is versus the yield, or the risk premium that we're achieving for being in those sectors. Leveraging all of those sectors, leveraging different coupon structures and calls — those are all the ways that we express our views on where there's relative value opportunity in the marketplace.

Crigger: Can you speak to the diversification benefits of munis in a portfolio?

Gotelli: For the end advisor, the asset class provides some important benefits such as low correlations or even negative correlations to other asset classes. We have a correlation matrix that shows investment grade municipals and their correlation to the S&P 500 Index (over the trailing 10 years) is nearly zero. For high yield municipals it's less than 0.25.

Crigger: That sort of non-correlation is hard to find nowadays.

Gotelli: Exactly. But when you look at what corporate high yield provides you, it's obviously a different lever, right? That's going to have much more correlation to the equity market.

So when an advisor thinks about the municipal market as a whole, some of those factors that can really benefit a client in their broader portfolio come from the levels of credit and credit exposure, rather than just high quality, passive duration exposure. We take the view that having that broad view of the marketplace and having a full representation of the market helps provide the end user of the product that level of diversification over time.

Crigger: You have a municipal bond mutual fund, and you have the American Century Diversified Municipal Bond ETF (TAXF). What is the advantage of using an ETF wrapper for this strategy?

Gotelli: When we designed TAXF, we were really trying to answer that question. We'd stand in front of clients and say, "We have a tax exempt core intermediate fund, we have a tax exempt high yield fund, and we view it as a core plus a satellite in terms of how you want to manage your duration and credit exposure." And what we found was investors telling us, "Well, you all are the experts. For those of us that believe in active management, we're willing to allow you to make that call for us."

That's what TAXF obviously is for. It tends to be a tool for advisors willing to allow us to make that allocation for them, allow us to take advantage of those opportunities — intra-month, intra-day, whenever we see opportunity. We don't have to wait for a model to rebalance to tell us how to position the portfolio. We're doing this, more or less, in real time.

I think that fits really well for advisors that are attracted to the ETF structure as a whole. Then, as a traditional mutual fund manager, the benefit of the ETF structure has become very apparent to me. Whether it's the levels of liquidity that the exchange offers and that the market offers to the redemption and creation process allowing for some tax efficiency. You allow somebody who's traditionally focused on taxes — like a tax-exempt mutual fund — to really have an extra tool in their toolkit through that creation and redemption process to help manage the tax exposure in the portfolio.

Crigger: What are folks still overlooking when it comes to muni bonds?

Gotelli: Right now, I think an eye on the duration impact in the portfolio is going to be key in the near term. But in terms of allocation to munis overall, I think that most investors are still underweight. Most could benefit from the tax exemptions, especially for the advisors with a higher net worth clientele in high tax states across the country.

I do think that it is an asset class to hold for the long term, which will help mitigate some of the volatility investors may experience. We have examples where we show just the holding period returns, where you rarely have had two years in a row where you have negative returns. So having a time horizon and being in the market for more than a short-term trade, that's important too. Because this is an investment vehicle, I wouldn't call it a trading vehicle. It allows us to use those levers that we just described to strive to achieve those returns over time. That's how I would view the best way to use the asset class, and TAXF is a great way to access it.

ETF TRENDS

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