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High-Yield Munis Could Be Interesting.

Broadly speaking, bonds are lagging again this year. As of April 2022, the Bloomberg U.S. Aggregate Bond Index was lower by 3% year-to-date. This slump affects municipal bonds, highlighted by a 1% decline since the start of the year by the ICE AMT-Free US National Municipal Index. However, there are pockets of strength in the municipal bond space. Perhaps to the surprise of some fixed investors, muni bullishness can be sourced via high-yield fare.

For example, the VanEck High Yield Muni ETF (HYD) is higher by almost 1% year-to-date, confirming investors have been rewarded for adding a bit of risk with municipal debt.

High-yield implies higher risk when it comes to bonds. Still, the $2.91 billion HYD, which turned 15 years old in February, isn't excessively risky. The ETF allocates 31.42% of its weight to bonds with investment-grade ratings, compared to 26.30% with junk grades.

HYD Risk Could Be Worth the Reward

Indeed, an ETF such as HYD carries more risk than an investment-grade equivalent. However, the VanEck offering compensates investors for that risk as highlighted by a 30-day SEC yield of 4.49%. That is well above what we find on municipal bond funds with higher credit quality. Additionally, HYD could merit attention by tactical, affluent investors.

"We believe high-yield munis are an asset class that carries additional risks, but is worth consideration by investors in higher tax brackets who are comfortable taking added risks," noted Cooper Howard of Charles Schwab. "If the economy continues to remain resilient and yields don't move substantially higher, the total return prospects for high-yield munis look favorable, in our view."

Some fixed income experts argue that current yields on high-yield munis aren't elevated enough to merit consideration. However, that's also a sign prices on these bonds, including HYD holdings, weren't as adversely affected by rising interest rates. On that note, HYD outperformed "the Agg" by 270 basis points over the past three years.

We can attribute some of HYD's less bad performance over that span to an effective duration (currently 6.74 years) that puts the ETF in intermediate-term territory. That segment of the bond market is typically less vulnerable to rising rate than long duration debt.

High-Yield as an Alternative

As Schwab's Howard noted, high-yield munis may currently be a credible alternative to junk corporate bonds for wealthy market participants.

"The difference in yields fluctuates, but more often than not, high-yield corporate bonds yield more than high-yield munis because of their lack of tax benefits," he concluded. "Today, the difference in yields is about 3.2% which is above the longer-term average but near the level over the past two years. In other words, high-yield munis are not overly attractive at these levels, but also not overly

unattractive, in our view.”

ETF TRENDS

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