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Rout Opens Opportunity for Investors Seeking Yield.

The worst rout in the $3.7 trillion municipal-bond market in more than two years is proving a gift for wealthy investors buying through brokers and professional asset managers who see a chance to make long-term money.

With state and local debt at its cheapest since April 2011, such buyers are grabbing munis with yields at record highs, according to data compiled by Bloomberg. For example, Ace Ltd. (ACE), a Zurich-based property and casualty insurer, increased its muni holdings by 15 percent in the first six months of this year.

Meanwhile, individuals who invest in munis mainly through mutual funds, a strategy that requires less money, have withdrawn the most since February 2011 on concern that the Federal Reserve will scale back bond purchases, sending interest rates higher and eroding the value of the funds.

"It's a fantastic opportunity" as withdrawals force sales by funds, said Peter Kuhn, a 52-year-old business owner from San Jose, California. After investing more than $1 million in munis through online broker-dealers, Kuhn said he has been buying more in the past two weeks.

One investment — $250,000 of general-obligation debt issued by San Ysidro School District in San Diego County — will yield almost 7 percent, Kuhn said by telephone. The zero-coupon bonds will pay debt and interest in future years, "and then you get all the tax-free benefits," he said.

Getting Out

Mutual funds holding U.S. municipal bonds hemorrhaged $24.5 billion over 15 weeks through Sept. 4, the most since February 2011, Lipper US Fund Flows data show. As investors shunned tax-free fixed-income investments, yields on benchmark 30-year munis rose to 4.76 percent yesterday, near the highest rate since April 2011, data compiled by Bloomberg show.

Amid the withdrawals, smaller trades have increased. In July and August, transactions of $100,000 or less, typically involving individual investors, accounted for 85 percent of municipal-debt trading, according to Municipal Securities Rulemaking Board data. That's the highest proportion of such trades for those two months since at least 2006, the data show.

Other investors adding munis to their holdings include property and casualty insurers such as Ace. The company had $4.45 billion of the securities, based on fair-market value, as of June 30, compared with $3.87 billion at the end of last year, regulatory filings show. State and local debt accounted for 7.9 percent of its fixed-income investments, up from 6.8 percent on Dec. 31.

CNA Buying

Stephen Wasdick, a spokesman for Ace, declined to comment on why the insurer has boosted its muni investments.

CNA Financial Corp. (CNA), a Chicago-based insurance holding company majority-owned by Loews

Corp., invested $500 million in the securities from April through June and may invest $500 million more before the end of this month, said James Anderson, senior vice president for financial planning. The company tends to buy local debt maturing in at least 20 years, he said.

“The combination of being able to lock in the higher yields for such a long period of time, which matches our liabilities, makes it very attractive,” Anderson said.

CNA’s second-quarter investments in munis brought its holdings in the securities to $10.1 billion as of June 30, regulatory filings show.

Muni Magnetism

Buyers of U.S. Treasuries and taxable corporate debt are also investing in munis for their higher relative yields, Justin Hoogendoorn, a managing director at BMO Capital Markets in Chicago, said in a Sept. 4 report. “Our trading desk has seen increased purchase activity from crossover buyers, likely due to these valuations,” he said.

The 4.76 percent yield on benchmark 30-year munis compares with an almost 3.9 percent rate for Treasuries with similar maturity, data compiled by Bloomberg show. The ratio of the yields reached 122 percent yesterday, up from about 89 percent on Jan. 3 as muni prices have fallen relative to U.S. government debt. In the past week, that proportion has hovered near a level last reached in December 2011, according to the data.

Negative headlines in recent months have fueled withdrawals from muni-focused mutual funds, Hoogendoorn said. Detroit’s record bankruptcy filing July 18 led to delays in bond offerings by Michigan issuers amid concerns that defaults may increase in cities burdened with unfunded liabilities and rising costs.

Fund Drops

The exchange-traded iShares National AMT-Free Municipal Bond Fund fell 9.7 percent from April 30 through yesterday, when it closed at $101.03 a share, its lowest closing price since April 2011. By comparison, it dropped 12 percent from Sept. 9, 2008, less than a week before Lehman Brothers Holdings Inc.’s bankruptcy filing, to Oct. 10 of that year, when the U.S. announced plans to prop up Wall Street banks by buying shares.

As individual investors see the value of their muni mutual funds decline, they sell to avoid deeper losses, said Ed Reinoso, chief executive officer of New York-based Castleton Partners LLC, which manages $250 million of fixed-income securities for people with a minimum of $2 million to invest.

“It’s become such a stampede that it’s created a real opportunity,” Reinoso said. “We’ve been more active in the past two months than we had been in the last 18 months.”

On Aug. 20, Reinoso bought Detroit School District notes maturing in a year with a yield of almost 4.4 percent, about 14-fold more than top-rated munis of similar duration, data compiled by Bloomberg show. The notes, rated SP-1, Standard & Poor’s second-highest grade, were issued through the Michigan Finance Authority, to be repaid with state-aid revenue.

It was the first debt sale by a Detroit issuer since the city sought court protection.

Looking Deeper

Looking past the negative headlines and “digging out situations that are extraordinary” gives investors higher yields on securities with a reliable repayment stream, Reinoso said. Such was the case with the school notes, he said.

“The principal and interest is already funded by the state,” Reinoso said. “So you’re not buying a Detroit school district, you’re buying the state of Michigan.”

Reinoso and Kuhn, the California investor, said they are focused on fixed principal and interest payments that they can collect tax-free rather than possible price changes of the debt.

A zero-coupon San Ysidro School District bond rated BBB-, one grade above junk, and maturing August 2034 last traded Aug. 29 with an average yield of about 6.6 percent, data compiled by Bloomberg show. The bonds are backed by Assured Guaranty Ltd. (AGO)

For investors in the highest federal income-tax bracket of 39.6 percent, that’s a taxable-equivalent yield of almost 11 percent.

Making Rent

“I view each muni bond that I own as an apartment,” said Kuhn, a co-founder of IBP Insurance Services, an employee-benefits consulting firm. “It just pays me every day, every month, every year. If I invest my money prudently and if I can get 6 percent or 7 percent year in and year out, I’m good and I don’t have to worry.”

In the broader market, states and municipalities plan to offer $5.5 billion of long-term debt next week, led by a $758 million New York State Urban Development Corp. personal income-tax revenue deal, according to data compiled by Bloomberg.

At 3.14 percent, yields on benchmark 10-year munis are at the highest level since April 2011. The interest rate compares with about 3 percent for similar-maturity Treasuries.

The ratio of the yields, a measure of relative value, was about 105 percent yesterday, compared with a five-year average of 101 percent. The higher the figure, the cheaper munis are compared with U.S. government debt.

By Michelle Kaske