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After Setbacks, Municipal Bond Sector Is Looking Up.

THE municipal bond market has been judged lately more by its failures than its successes, and the judgment has been harsh.

Interest rates on municipal issues rose last year, taking the yield on the Bond Buyer 20-bond municipal bond index to 4.75 percent from 3.85 percent, the largest increase in more than 30 years. And as prices move in the opposite direction from yields, the average municipal bond mutual fund tracked by the research firm Morningstar lost too much on its holdings for interest payments to make up the difference. Investors withdrew a net $58 billion from muni mutual funds last year as returns deteriorated.

A similarly sharp rise in yields on long-term Treasury bonds played a big role in the poor performance of municipal issues, analysts say, but so did some civic bankruptcies. The California cities of Stockton and San Bernardino filed for protection from creditors in 2012, and Detroit did the same last summer in the largest case of its kind ever.

Investors' faith was shaken further when prices plunged on bonds issued by Puerto Rico. The American territory has $70 billion in debt, a prodigious amount relative to the size of its economy, which has been inundated with difficulties.

Interest on Puerto Rican munis is exempt from federal and state income tax, no matter where a bondholder lives. That has made them popular with well-off investors nationwide, especially in high-tax states like New York and New Jersey, who otherwise receive the state tax deduction only on bonds issued in their home state.

But Puerto Rican issues became far less popular last year, with some yields doubling to about 10 percent in the face of concern that the island's credit rating would fall to junk status. It fell to that level last week when two ratings agencies downgraded it.

Developments on Wall Street and in Puerto Rico and Detroit have depressed municipal bonds, but their tax advantages and safety, compared with stocks or some other assets, almost always make them suitable holdings for investors of a certain age and a certain income, whatever the short-term outlook, financial advisers say. And the market is expected to improve in 2014 as fundamental financial conditions that influence it become more favorable.

"I'm more optimistic this year," said Alan Schankel, a municipal bond strategist at Janney Montgomery Scott. "I think the rising-rate environment will continue, although not dramatically. I think municipals will do better than other fixed-income investments." He said that while downgrades have exceeded upgrades for the last few years, "I think that will reverse toward the end of the year."

What investors are facing right now, he noted, are tax increases that went into effect a year ago but are likely to become palpable only in April, when the first returns are due that take the increases into account. Among the changes are a jump in the top federal income tax rate to 39.6 percent from 35 percent and a new 3.8 percent tax on investment income for high earners that was included in the Affordable Care Act. The increases will make well-off taxpayers “realize how valuable the tax-free status of municipal bond income is,” Mr. Schankel said.

At the same time, state and local governments have adjusted to their straitened circumstances since the financial crisis by curbing spending, he said. That helps munis in two ways, by improving their ability to meet bond payments and by limiting their need to float new issues. Add it all up, he said, and “the supply-demand dynamics are a little more favorable for municipals.”

Strategists at Citigroup also anticipate a healthier market. “We remain cautiously positive on our outlook for municipal credit over the next year, though some issuers will face their share of challenges,” they wrote in a recent note to clients. “Most state and local governments will continue to take the steps needed to balance available revenues with needed expenditures, minimizing the magnitude of actual payment defaults.”

They also highlighted the prospect of increased tax receipts as the economy recovered.

States are also addressing more effectively one of the biggest threats to financial stability that they and their cities face: runaway pension obligations. A report by Evercore Wealth Management noted that several states passed laws to limit their liability for retirement benefits to government employees.

California is expected to go further and place an initiative on the November ballot to amend the state Constitution to “enable cities to modify their existing pension programs, preserving only the vested earnings for existing employees,” the report states. “From the investor’s point of view, it would at last tackle what has become a major — and increasingly detrimental — factor in the long-term credit viability of municipal bond issuers.”

Whatever developments may affect the market, financial advisers recommend a healthy allocation to municipal bonds for almost anyone with a moderate to high tax liability.“If you’re paying 40 percent federal and state combined, at least half of your bond allocation should be in munis,” said David Molnar, a partner at HighTower San Diego, part of the HighTower nationwide advisory firm. “If you’re in higher tax brackets, then I would go higher, even to 85 percent.”

Elizabeth Ruch, a financial planner at Waddell & Reed in San Diego, counsels anyone middle-age or older and in higher tax brackets to keep about 20 percent of total investment assets in bonds, with all or nearly all of it in munis. Most investors should own funds rather than single bonds in the interest of creating a broad mix of issues, she added, and because professionals have better knowledge of what can be an opaque market with limited information available to novices.

Ms. Ruch finds municipal bonds especially good for well-off people past 70 1/2, who are required under federal law to take minimum distributions from their retirement plans. She contends, though, that most young investors should emphasize capital growth over the tax-free income of munis. “No one under 30 needs munis unless they’re as rich as Bill Gates,” she said. “They can take the risk of the stock market.”

As municipal bonds demonstrated last year, owning them can be risky too, but not as much as some think, Mr. Molnar said.

“Everything we’re hearing from Wall Street in the past six months is that bonds are bad,” he said. “Our view is that that’s overdone. You should own stocks, too, but munis and other bonds provide steady, consistent income and diversification.”

By CONRAD DE AENLLEFEB. 10, 2014