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Lipper Winners Answer the Muni Bond Riddle.

(Reuters) – One could forgive municipal bond investors for being confused. While the average muni bond was down 2.6 percent in 2013, making it one of the worst-performing bond sectors this year, munis are already up 3.1 percent through March 19, making it one of the best.

Many of the conditions that existed last year continue today. Muni investors are still worried about the outcomes of the financial struggles of Detroit and Puerto Rico. And there is still persistent fear of rising interest rates decimating bond values. (Bond prices move inversely to rates.)

So what gives?

Reuters asked a number of 2014 U.S. Lipper Fund Awards' winners for answers.

While Detroit's bankruptcy played a role last year, manager Peter Hayes of BlackRock Strategic Municipal Opportunities Fund , a winner of the 2014 U.S. Lipper Fund Awards, says the spike in interest rates that occurred last May did most of the damage.

From May 1 through the end of July, the 10-year U.S. Treasury bond yield rose from 1.66 percent to almost 3 percent as investors panicked about the Federal Reserve bank scaling back its bond-buying program.

While investor concerns about rising rates persist, Hayes says bonds are now priced more appropriately.

"When yields were very low in 2011 and 2012, investors began to take on too much risk, buying high-yield bonds and bonds with long durations," Hayes says.

But now, you can get a 3.35 percent tax-free yield on a 10-year A-rated muni compared to just 2.78 percent on a taxable 10-year Treasury bond. And you can get up to 3 percentage points extra if you're willing to buy regular high-yield municipals, and even more than that for the truly distressed plays in Detroit or Puerto Rico.

Aside from the added yield, driving the comeback is a shortage of muni bond supply, where there is a 30 percent decline in new issuance this year, Hayes says. Add to that the fact that income tax rates on the wealthy went from 35 percent to 39.6 percent – or 43.4 percent if you include the new 3.8 percent Medicare tax on the ultra-rich – and you've got the makings of a rally.

Arguably the best values in the muni sector are now in high-yield bonds. To take full advantage of the sector, Hayes tweaked his fund's investment strategy and changed its name this January from the BlackRock Intermediate Municipal Fund to its current Strategic Municipal Opportunities.

This has given him greater latitude to buy high-yield bonds, the exposure for which he's doubled from 7 to 14 percent this year. And he can play offense or defense with the maturities of the bonds he owns depending on which way he thinks rates are going. (Long-term bonds are more sensitive to rates than short-term bonds.)

Most of the other 2014 U.S. Lipper Fund Award Winners are also fans of high-yield debt.

“Despite the headlines about Detroit and Puerto Rico, default rates in the high-yield municipal bond market have stayed very low,” says Troy Willis, co-manager of the Oppenheimer Rochester AMT-Free Municipal Fund.

Indeed, Willis sees the negative press about Puerto Rico as an opportunity. His fund has a 10.2-percent Puerto Rico weighting.

“We are the largest institutional holder of Puerto Rico bonds,” Willis says. “We don’t think it will default like Detroit.”

Detroit’s population declined by 60 percent in the last 40 years while Puerto Rico’s has grown 2.2 percent, increasing the number of people who can pay taxes to cover its muni bond debt, Willis says.

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Also, the island commonwealth recently shifted its pension plan for government employees to a more affordable 401(k) retirement plan and increased the age at which existing pensioners can receive their benefits. That’s bad for employees but good for Puerto Rico’s budget. Its deficit has been shrinking from $3.3 billion on June 30, 2009, to an estimated $650 million by June 30, 2104, according to Willis.

The yields on Puerto Rico debt are extraordinary in a low-rate environment.

“I can find Puerto Rico Electric Power Authority munis yielding 10 percent tax-free,” says manager Michael Walls of Ivy Municipal High Income, another Lipper winner and Puerto Rico fan.

That translates to a 16.6 percent tax-adjusted yield for those in the highest 39.6 percent bracket. General obligation bonds issued by the Puerto Rican government currently yield upwards of 8 percent – or 13.2 percent on a tax-adjusted basis.

Still, not every Lipper winner is buying the Puerto Rico story.

Even if some newly issued 2-year Puerto Rico bonds yield 10 percent, the average recovery rate on defaulted municipal bonds for investors is only 60 cents on every dollar invested, says Chris Ryon, co-manager of the Thornburg Limited Term Municipal Fund.

“You could make 20 percent but lose 40 in two years,” he says. “Not such a good deal.”

Of this year’s muni winners, Ryon’s fund is probably the most conservative strategically. Ryon only holds high-quality investment-grade bonds rated BBB or better. He also keeps the maturities of his bonds less than 10 years so that the fund is less sensitive to interest rates.

He thinks the best values can be found in bonds within the 7- to 10-year maturity range.

He likes 10-year AA-rated bonds from Rhode Island which has “a great Treasurer,” pension spending that’s under control and bond yields of 3.2 percent – about 0.70 percentage point higher than the average AA-rated bond.

BlackRock’s Hayes favors B-rated municipal airport bonds in New Jersey issued by companies such as United Continental Holdings or US Airways. These yield in excess of 5 percent – or 8.3 percent tax adjusted. Maybe that's not at Puerto Rico levels but it beats the 2.78 percent you'll get on a 10-year Treasury note any day.

By Lewis Braham

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(Editing by Lauren Young andBernadette Baum)