
Midterm Muni ETFs Hit Sweet Spot.

Investment-grade municipal bond ETFs have now delivered nearly twice the returns relative to the broad high-grade bond market year-to-date, thanks mostly to ongoing supply/demand imbalances. But within the high-grade muni space, it's intermediate-term munis that are proving to be one of the sweet spots.

In a broad sense, a look at two broad-based bond funds exemplifies the strong performance of the investment grade muni market relative to the aggregate U.S. investment-grade fixed-income segment. The chart below shows the $3.35 billion iShares National AMT-Free Muni Bond ETF (MUB | B-75) delivering total returns of 6.7 percent since the beginning of the year, while the $17.7 billion iShares Core U.S. Aggregate Bond ETF (AGG | A-97) has climbed nearly 4 percent in the same period.

Low Supply, Big Demand Supports Munis

The strong muni price performance, which has kept yields anchored, is tied to ongoing low issuance of high-grade municipal bonds relative to fund-industry demand for these bonds, J.R. Rieger, global head of fixed income at S&P/Dow Jones Indices, told ETF.com.

"Concerns over rising rates are offset by not enough supply, which is holding down yields," he said. "That has been going on for some time, and there are no signs we are going back to historical issuance trends soon."

While that's a supportive dynamic for the overall high-grade muni market, it's been particularly good for midterm munis, and specifically for debt in the 9- to 10-year range.

"Intermediate munis have a nice coupon and shorter duration, which offers investors a pretty significant cushion, or premium, that should soften the blow when prices come down," Rieger noted.

The belly of the curve—the 9- to 10-year range—has outperformed the broad market with returns of 7.4 percent year-to-date, compared with 6.3 percent for the aggregate muni market, according to S&P data.

Longer Duration Not Yielding Enough To Justify Risk

For perspective, long-term high-grade munis have rallied 14 percent in the same period, but they bring with them a lot more exposure to duration risk. And investors get 2.1 percent in yield for taking on that additional duration risk, while midterm munis are yielding 1.7 percent.

"The incremental yield you get for longer-dated munis has to be valued in regard to risk," Rieger said. "The long-dated basket will fall faster than the intermediate basket [when rates rise], and right now you are being rewarded nicely for lower-duration risk, so why not take advantage of this market?"

ITM Vs. MUNI

In the midterm high-grade muni space, there aren't all that many ETFs to choose from, but there are two funds that stand out in our Analytics.

One fund stands out for being ETF.com's Analyst Pick as the best in the segment thanks to the solid, liquid, and broad exposure it provides. The other fund stands out for being what we call ETF.com's Opportunities Pick, or a fund that offers an alternative take on the segment.

ITM: ETF.com's Analyst Pick

The Market Vectors Intermediate Municipal ETF (ITM | B-91) is our Analyst Pick.

It tracks a market-weighted index of tax-exempt municipal bonds dated with nominal maturities of 6 to 17 years. The 705-holding portfolio has current effective duration of 7.4 years and a 30-day yield of 2.3 percent.

ITM is the largest in the segment, with more than $687 million in assets, and it's also relatively cheap, with a 0.24 percent expense ratio. It's a liquid fund, but it still trades with an average spread of 8 basis points, which means investors are shelling out roughly $32 per $10,000 invested to own it.

"ITM's strong Fit to the market and ample liquidity makes it a solid choice for investors and earns it our Analyst Pick ribbon," ETF.com Analytics says of the fund.

However, that "endorsement" comes with a warning. Investors need to be aware that ITM often lags its benchmark. Tracking difference can translate into higher costs to investors over time. What's more, in the past 24 months, ITM lagged its underlying index by as much 100 basis points at times—a difference that often meant the fund was underperforming its benchmark by that much.

MUNI: ETF.com's Opportunities Pick

The Pimco Intermediate Municipal Bond Strategy (MUNI | B-54) is an actively managed fund that serves up tax-exempt income by investing in high-credit-quality municipal bonds with maturities of 1 to 17 years.

The 169-holding fund essentially plays in the same playground as passively managed ITM, but enjoys the freedom to tilt any way it sees fit based on a portfolio manager's discretion. That active approach is what makes this fund a unique opportunity in the space.

In MUNI's case, the active decision-making currently translates into a midterm muni portfolio that's shorter in duration than counterpart ITM. MUNI's effective duration currently sits at 4.7 years, for a lower 30-day yield of 1.35 percent.

Active management also means a higher price tag: MUNI carries a 0.35 percent expense ratio—more than ITM's price tag, but to be fair, a relatively cheap cost for an active fund.

Liquidity is another issue. MUNI trades with an average spread of 11 basis points—a wide enough spread that calls for the use of limit orders for protection, and one that bumps up its overall cost of ownership to about $46 per $10,000 invested.

Revenue vs. General Obligation Bonds

ITM and MUNI are also different in terms of allocation.

MUNI underweights general obligation bonds in favor of revenue bonds and some Treasurys. Only 15 percent of the portfolio is tied to GO bonds—less than half the allocation seen in the broad segment benchmark. Revenue bonds represent 65 percent of the portfolio.

That's important because GO bonds are perceived as lower risk than revenue bonds due to their method of repayment to creditors. GOs are essentially backed by the full credit of the issuer, and can rely on any type of revenue including taxation—think property taxes, sales taxes, etc.—in order to repay investors.

Revenue bonds, on the other hand, count on revenues that are generated from the project being financed by the bonds themselves in order to repay creditors. If these bonds are being sold to fund a new transportation system, for instance, the issuer will rely on revenues from ticket sales to pay back creditors.

ITM allocates about 56 percent to revenue bonds, and 42 percent to GO bonds, according to our data. That heavier allocation to the "safer" GO bonds could help drive down yields for the overall portfolio.

Passive Trumping Active In YTD Performance

Year-to-date, ITM's passive approach to midterm high-grade munis is paying off relative to the active MUNI, with a performance that's nearly double that of its competitor, as the chart below shows.

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Charts courtesy of StockCharts.com