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## Your Three-Step Municipal Bond Workout.

The municipal market has been on a tear this year. And I'll be the first to admit – we didn't necessarily expect it. In fact, few people anticipated interest rates would fall (and bond prices rise) as they have in the first seven months of the year. Munis also benefited from an imbalance in supply and demand, which helped support pricing, and from a collective "ouch" from taxpayers when they saw their 2013 tax bills. Tax-exempt munis looked that much better.

So, what's next? We think it's time to protect those gains rather than reach for more. We also think it makes sense to prepare for more volatile interest rates than we've seen over the past several months, particularly as the Fed gets closer to abandoning the zero-interest-rate policy it put in place in December 2008. More precisely, we'd suggest three actions to consider now:

1. Flex more muni muscle with a flexible municipal fund. "Unconstrained" investing has gotten quite a bit of press this year. My colleague Rick Rieder wrote about it here , and BlackRock recently published a new paper on the topic. It's a concept that's just taking hold in the muni space, and we think it makes a lot of sense. Essentially, an unconstrained municipal strategy, such as our own Strategic Municipal Opportunities Fund , is a flexible, one-stop solution that invests across the entire municipal spectrum. It's not limited to bonds of a particular credit quality or maturity date. Importantly, we are able to manage interest rate risk by adjusting our duration as needed in an effort to mitigate the losses that accompany a rise in interest rates. It's a kind of flexibility not previously available, and we think it can add a lot of diversification to your muni allocation at a time when market uncertainty demands a high level of adaptability.

2. Work the barbell. The middle portion of the municipal yield curve (short and intermediate maturities) is looking relatively pricey at this juncture. For that reason, we suggest a barbell approach that favors maturities below two years on one end (for trading flexibility) and above 15 years on the other for some potential yield pick-up. While short-term and intermediate munis are looking expensive, we think longer maturities continue to appear attractive versus Treasuries and, we believe, represent absolute and relative value.

3. Leave the heavy lifting to the pros. And by "heavy lifting," I mean credit research. While overall creditworthiness is improving across the municipal landscape, and municipal bonds in general have had lower default rates than corporate bonds, no two issuers, credits, you name it, are exactly alike. You need to understand issuers' ability to pay back debt, but also their willingness . This isn't easily assessed, and there's the potential for new precedents to arise out of cases such as Detroit . Professional eyes are priceless here, as a wrong move (particularly if you're buying individual bonds) can make or break a muni portfolio. Our credit research team offers insight in their quarterly Municipal Credit Highlights.

Overall, municipal bonds continue to be a favorable fixed income option here at BlackRock, as noted in our Mid-Year Outlook . Munis remain a high-quality asset class offering yields that today rival those of Treasuries and many corporate bonds before tax – and look even better after. Caution is warranted after the market's more than 6% gain through July, but in our estimation, that does not diminish munis' appeal.

By BlackRock, August 14, 2014, 09:00:43 AM EDT

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