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Build America 21% Outperforms Local-Government ETFs: Muni Credit.

Four years after the last Build America Bonds were issued, the taxable debt is delivering the biggest gains among exchange-traded funds focused on municipal securities.

The SPDR Nuveen Barclays Build America Bond ETF (BABS) proved the best choice during a record-setting year for muni exchange-traded funds. Its 20.6 percent gain through Dec. 23 was highest among the 26 muni ETFs tracked by Bloomberg.

Build Americas benefited this year from their longer maturities, which are luring buyers seeking to pad returns with yields close to generational lows. The average maturity of the $113 million SPDR Nuveen ETF is about 25 years, according to its website. Munis due in 22 or more years have earned 14.9 percent in 2014, beating shorter maturities, according to Barclays Plc data.

“The market’s been willing to trade the Build America Bond sector as a long maturity, a long-duration asset class, and that’s helped drive the returns,” said Bart Mosley, co-president of Trident Municipal Research in New York.

Leaping Assets

With the $3.6 trillion municipal-debt market earning 8.7 percent this year, the most since 2011, exchange-traded funds have emerged as a popular way to tap the rally. Muni ETFs had $13.4 billion of assets as of Sept. 30, the most ever and up from $7.8 billion three years earlier, according to Federal Reserve data.

ETFs are similar to mutual funds that track indexes of equities, bonds, commodities or geographic concentrations. They can be bought and sold during the trading day, allowing investors to jump on market moves more quickly than with mutual funds. U.S. ETFs have about $1.7 trillion in assets, Bloomberg data show.

Build America obligations were created under President Barack Obama’s 2009 economic stimulus, and municipalities nationwide sold $188 billion of the debt before the program expired at the end of 2010, data compiled by Bloomberg show.

States and localities used the bonds to pay for infrastructure work, and received a 35 percent federal subsidy on interest payments. Congress reduced that support by 7.2 percent last fiscal year and 7.3 percent this year as part of federal budget cuts, according to the Internal Revenue Service.

Treasuries Tailwind

A rally in Treasuries has helped propel gains in Build America Bonds, said Dan Close, senior vice president at Nuveen Asset Management in Chicago and manager of the Build America ETF. Yields on 30-year federal debt have fallen by about 1.1 percentage points this year to 2.83 percent, the first annual decline since 2011, data compiled by Bloomberg show.

The ETF benefited from “a generally declining interest-rate environment and, to some extent, some spread narrowing,” Close said.

The performance of Build Americas sold by California underscores the rally in the securities.

Build America Bonds that mature in November 2030 traded Dec. 24 with an average yield of 2.96 percent, or about 1.1 percentage points more than Treasuries, Bloomberg data show. That gap has shrunk by more than half this year. Tax-exempt munis with a similar maturity yield about 2.46 percent.

The higher interest rates are a draw for investors, said Thomas Boccellari, an ETF analyst at Morningstar Inc. in Chicago. Improving state and local budgets also give bondholders confidence that municipalities will repay their obligations, he said.

Fiscal Confidence

“Not only was the fund getting a nice yield relative to other municipal bonds, but it was also getting that same increased price return from the underlying fundamentals of the municipal bonds,” Boccellari said.

State tax collections last quarter rose 4 percent from a year earlier, according to a report from the Nelson A. Rockefeller Institute of Government in Albany, New York. It was the biggest quarterly increase in a year.

Build Americas have maintained their value in part because a finite amount of the debt exists, Mosley and Boccellari said. Investors also face a limited universe of long-term corporate debt, they said.

“Not only are taxable munis attractive credits in and of themselves, but if you want to buy 20- or 30-year taxable bonds, you don’t have a lot of options,” Mosely said.

The prospect of higher interest rates next year as the economy grows may hinder the ETF’s performance, said Mosley.

Yields on 30-year Treasuries, a benchmark for borrowing rates, will climb about 0.9 percentage point to 3.7 percent a year from now, according to the median forecast of 53 analysts in a Bloomberg survey.

Even in that scenario, the extra yield on Build America Bonds will provide a cushion, Boccellari said.

“Even if rates go up, demand for BABs should continue in 2015 for their relative yield,” Boccellari said.

Bloomberg Muni Credit

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