Don’t Write Off High-Yield Munis.

Another April 15 has come and gone, and minimizing the taxes you’ll owe next year may be top of mind. For most investors, that means checking out municipal bonds. And if you want more income, high-yield munis may look tempting.

The average 12-month yield for Morningstar’s high-yield muni category is 4.34%, compared with 2.53% for intermediate municipal bonds. A 4% or 5% payout is impressive enough when the 10-year Treasury yields 1.9%, but for investors in the top bracket, that’s equivalent to a 7% yield.

Yet high-yield munis are remarkably controversial. Their “high” yields are still at historical lows, though the risks are not: Rising interest rates threaten, and many investors are still smarting from Puerto Rico, Detroit, and other troubled issuers.

High-yield muni funds often buy low- or unrated munis, says John Miller, co-head of fixed income at Nuveen Asset Management, which manages Nuveen High Yield Municipal Bond fund (ticker: NHMAX) and an exchange-traded index fund, SPDR Nuveen S&P High Yield Muni Bond (HYMB). They are usually revenue-backed, issued to fund a new project that will bring in the revenue to pay back investors.

Even so, “you’re not getting paid to take that risk,” says Nicholos Venditti, who helps run Thornburg Strategic Municipal Income (TSSAX), which has just 6% of its $253 million in assets in high-yield munis—though it can go as high as 50%.

Two summers ago, high-yield munis were much cheaper than they are today. That’s when Richard Bernstein, chief investment advisor at his eponymous firm, started investing. “When we took our position in July 2013, high-yield muni bond yields averaged roughly 250 basis points [2.5 percentage points] over Iraq bonds,” says Bernstein—an indication the market felt U.S. municipalities with poor credit were a bigger risk than the nation of Iraq. “That’s ridiculous.” Even as of last week, “they were still 44 basis points over Iraq bonds,” he says.

At current rates, he says he’s not adding more, but the asset class still makes up nearly 20% of various portfolios.

BUT DON’T WRITE OFF high-yield munis just yet. Krishna Memani, chief investment officer at Oppenheimer Funds, calls them “the best asset class of all for investors who can take advantage of the tax benefits.”

Municipalities, even those with below-investment-grade debt, still have much lower default rates than comparably-rated corporates. Miller is optimistic, noting that state and local tax collections are rising, and economic conditions in most cities are improving. Moody’s Investor Services says municipal finances are better than they were during the 2008 financial crisis or in 2013 when Detroit’s bankruptcy and Puerto Rico’s financial woes rattled the sector.

Investors who want the income bump should go with a broadly diversified, actively managed fund at a company with a deep research process, says Morningstar senior analyst Beth Foos. Most funds use leverage and hedging strategies, which are disclosed on fund Websites and in prospectuses. Nuveen, for example, is hedging a year of duration (to manage interest rate risk) and has 20% total effective leverage (it's capped at 30%). The greater the leverage, the bigger the risk if the market falls.

T. Rowe Price Tax-Free High Yield (PRFHX), run by Jim Murphy, is the only high-yield muni bond fund to earn Morningstar's gold ranking. Murphy says he focuses on managing credit risk. He's avoiding Puerto Rico and tobacco bonds. He likes hospital bonds, which have attractive yields, and some corporate-backed bonds, such as those issued by airlines, and transportation projects.

"Rates are historically low and spreads are tight," says Murphy, "That is always uncomfortable. But when I look at the global landscape, these are among the highest yields in the world."

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