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Flexible Muni-Bond Funds Attract Advisers.

More municipal-bond fund managers today have the freedom to range across a broad array of investments.

As a result, financial advisers are beginning to embrace these flexible funds as a possible hedge against rising interest rates.

At least six muni-bond funds have been launched or retooled to give their managers more flexibility to manage duration or buy below-investment-grade bonds, according to Morningstar Inc.

BlackRock Inc. revamped BlackRock Strategic Municipal Opportunities (MAMTX) last year, for example, to permit its management team to set its duration between zero and 10 years instead of the prior 3 to 10 years. Also, the team can invest up to 50% of its assets in below-investment-grade muni bonds.

In another example, Goldman Sachs Asset Management in December changed the name of its Goldman Sachs Municipal Income Fund to Goldman Sachs Dynamic Municipal Income Fund (GSMIX), and gave it the flexibility to buy junk bonds and target a broader range of maturities.

In addition to investors' concerns over the possibility of rising interest rates, the changes stem from an evolving muni-market landscape that provides more opportunity for fund managers to distinguish themselves and the asset-gathering success of flexible bond funds that are taxable, says Elizabeth Foos, a senior analyst at Morningstar.

She recommends that investors approach the funds with caution for now. Many are new and the funds generally carry the same risks as flexible bond funds as well as some that are particular to the municipal-bond market.

For one thing: muni-bond funds fish from a far narrower universe than do their taxable counterparts, Ms. Foos says, which can make it difficult to make quick and cheap changes to credit and interest-rate exposure. Also, because these funds may have wide latitude to shift investments, investors can suffer amplified losses if a manager makes a bad call.

"The combination of thousands of unique debt obligors, ambiguous legal pledges to repay debt, and the lack of timely and consistent disclosure on the part of municipal borrowers can make it difficult to find the right high-yield investment for a portfolio," she says. Also, junk bonds represent just a small portion of the muni market and can trade infrequently, she adds.

In addition, the market for credit-default swaps, and credit-default baskets that can be used to take broad-based exposure to credit risk, isn't as deep or as liquid in the muni markets as it is in the taxable markets, Ms. Foos says.

Making swift and significant adjustments to duration in a muni fund also can be challenging. Taxable managers can adjust a fund's sensitivity to changes in Treasury yields quickly and cheaply through the use of Treasury futures, and muni managers can adjust duration by changing their mix of longand short-maturity bonds or using Treasury futures, she says.

But trading securities to adjust interest-rate sensitivity can be expensive, Ms. Foos says, and using Treasury futures can be problematic because muni and Treasury yields don't always move in tandem. When that correlation breaks down, a muni portfolio hedged with Treasuries can behave in unexpected ways, something that caused headaches for many muni managers in 2008, she says.

Peter Hayes, head of the municipal bonds group at BlackRock, says Treasury futures aren't perfectly correlated to munis. But over the longer term, there is a high degree of correlation between the two markets.

As for liquidity issues, they exist throughout the fixed-income markets with smaller issuers, but "most asset managers aren't buying small, infrequently traded issuers," Mr. Hayes says. The average credit quality of the BlackRock portfolio is around A+, he adds.

Regardless of the risks, however, investors have begun embracing the funds.

About $2.44 billion has flowed into BlackRock Strategic Municipal Opportunities since its modification in January of last year through March 31, according to Morningstar. The fund gained 4% in the 12 months through April 20, while the Barclays Municipal Bond Index rose 5.6%, according to Morningstar.

Roger Oprandi, an adviser at Vega & Oprandi Wealth Partners in Miami, has been using some flexible municipal-bond funds, including BlackRock Strategic Municipal Opportunities and Goldman Sachs Dynamic Municipal Income.

"We're hoping that their managers will be able to navigate a rising-rate environment over time," says Mr. Oprandi, whose firm is affiliated with Ameriprise Financial Services.

He's using the allocation to complement clients' municipal-bond holdings. In a portfolio calling for a 25% allocation to munis, for example, he might invest 10% in a flexible muni-bond fund. Mr. Oprandi says he hasn't committed more to the funds partly because of their short track records.

Melissa Joy, director of wealth management at the Center for Financial Planning Inc., is also using some of the funds as a portion of clients' muni allocations. The firm purchased the Thornburg Strategic Municipal Income (TSSIX) last summer and still holds it, says Ms. Joy, whose Southfield, Mich., firm manages $640 million.

But she does generally consider the funds more risky than a portfolio of general obligation bonds without the flexibility, and would discuss that risk with any client, she says. And managers of some of the new funds may have experience managing muni-bond funds, but no experience managing a flexible bond fund, she says.

"There will be some excellent opportunities within this space," Ms. Joy says. "But it will take a while to figure out who's got the staying power."

Chad Carlson, an owner of and director of research at Balasa Dinverno Foltz in Itasca, Ill., isn't using the funds yet for several reasons–one of which is their higher fees. He now uses two Vanguard funds for clients' muni allocations.

In addition, performance hasn't been great for any nontraditional bond funds generally, says Mr. Carlson, whose firm manages more than $3 billion. Most investors are concerned about rising interest rates, against which a typical defense is duration management, but it's very difficult for managers to predict when they should alter a fund's duration, he says.

That said, Mr. Carlson believes there's probably room for some flexibility in a bond portfolio. In fact, his firm does use small doses of it in client portfolios through taxable bond funds.

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