Municipal-Bond Funds Get Flexible

Some municipal-bond fund managers have more flexibility now. That means investors may need to exercise more caution.

In recent years, fund companies have changed the rules for some funds that specialize in tax-exempt muni securities to let managers buy debt that is riskier or that can be less sensitive to rising interest rates, according to Morningstar, the Chicago-based investment-research firm. The companies also have launched new muni funds that give managers a relatively free hand.

In December, for example, Goldman Sachs Group changed the rules governing a $600 million fund—and tweaked the name. The Goldman Sachs Municipal Income Fund became the Goldman Sachs Dynamic Municipal Income Fund, and managers now can invest up to 30% of its assets in below-investment-grade—or junk—muni bonds, which had been off-limits.

The fund also can vary its holdings to guard against rising interest rates to a greater extent than before. It charges annual fees of 0.79%, or $79 on a $10,000 investment. The fund has gained 4.9% over the past year, through Thursday, compared to a 5.3% gain in the Barclays Municipal Bond Index, according to Morningstar.

The $3.2 billion BlackRock Strategic Municipal Opportunities Fund made similar changes in January 2014. Managers now can invest up to 50% of the fund's assets in junk bonds, up from 20%, and have greater leeway to adjust the portfolio to limit the impact if interest rates rise. The fund charges annual fees of 0.88%.

The changes have come at a time when many bond-fund managers are concerned that if the Federal Reserve raises interest rates, their holdings could lose value and investors could withdraw money. In addition, junk bonds tend to pay higher interest rates, which can help fund managers boost returns.

Investors have responded to the changes with enthusiasm. They poured about $2.4 billion into the BlackRock fund between Jan. 1, 2014, and March 31 of this year, according to Morningstar. The fund has gained 3.7% over the past year.

But municipal-bond funds with broader mandates could leave investors vulnerable if, for example, fund managers are wrong about the direction of interest rates or have difficulty unloading their junk bonds, which can be thinly traded in the muni market, says Elizabeth Foos, a senior analyst at Morningstar.

"For now, it's probably best to approach these funds with caution," she says. Their limited track records and the greater latitude they give fund managers make it "difficult to know how they'll perform in a bout of real market stress and therefore how to best use them in the context of a broader portfolio," she says.

Some muni funds use Treasury futures to curb their sensitivity to interest rates, according to Ms. Foos. That can pose a problem because muni and Treasury yields don't always move in tandem—a phenomenon that caught some muni-bond fund investors off-guard when it occurred during the financial crisis in 2008, she says.

Peter Hayes, a portfolio manager for the BlackRock fund, says that over the long run, there is usually “a high degree of correlation” between Treasury futures and munis, limiting the risk.

In addition, Mr. Hayes says most asset managers don’t buy muni bonds issued by small, infrequently traded borrowers, so they are generally insulated from the risk that they will have difficulty unloading their holdings.

Roger Oprandi, whose firm, Vega & Oprandi Wealth Partners in Miami, is a franchise of Ameriprise Financial Services, says he has recently put some client money into muni funds that give managers wider latitude. In a portfolio calling for a 25% allocation to munis, for example, he might invest 10% of the overall portfolio in a flexible muni-bond fund.

“We’re hoping that their managers will be able to navigate a rising-rate environment over time,” Mr. Oprandi says. He says he hasn’t committed more to the funds in part because of their short track records.

Chad Carlson, director of research at Balasa Dinverno Foltz, an advisory firm in Itasca, Ill., isn’t using the funds, in part due to their higher fees.

Instead, Mr. Carlson, whose firm manages more than $3 billion, says he uses the Vanguard Intermediate-Term Tax-Exempt Fund and the Vanguard Limited-Term Tax-Exempt Fund, which both charge individuals 0.20% on a $10,000 investment.

Many investors are concerned about rising interest rates, but it is difficult to predict when they will rise and for a fund manager to adjust a bond portfolio in anticipation, Mr. Carlson says.

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