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A Lower-Risk Strategy for Muni Bonds.

Investors often are encouraged to think about the long run. But with municipal bonds, it also could pay to focus on the near term.

In recent months, investors have been lured by longer-term debt issued by U.S. cities, states and other government entities with yields that look relatively appealing in an era of low interest rates.

That contributed to a rally that pushed muni bonds up 9% across the board in 2014, including price changes and interest payments, according to Barclays.

But those bonds could be vulnerable if the Federal Reserve increases interest rates later this year, as many experts expect, because longer-term bonds tend to be more sensitive to changes in interest rates.

As a result, investors who worry that prices could fall sharply may be better off buying funds that hold short- or intermediate-term munis, which may not get hit as hard, according to experts.

"Sticking to intermediate and short-term funds of all flavors is generally a good idea," says Scott Brewster, president of Brewster Financial Planning in Brooklyn, N.Y. "I would get out of anything extremely long-term, because you're just an interest-rate spike away from heartache."

Investors who own short-term muni bonds—generally those that mature in less than five years—also could have an opportunity to get a bargain after interest rates rise, because bond prices likely will be lower and yields more favorable, experts say. The same is true of investors who are currently on the sidelines but are considering buying munis down the road. (Bond yields rise as prices fall.)

That kind of bargain could be particularly appealing to investors who turn to the \$3.7 trillion munibond market as a source of safe and stable income, often to help fund retirement. Those investors, who plan to hold the bonds more or less indefinitely, can be indifferent to short-term price swings.

"In those periods where the market sells off, I would view those as an opportunity to put some money to work and buy," says Peter Hayes, head of municipal bonds at investment giant BlackRock.

This year, the prospect of higher interest rates has helped put a damper on muni bonds, which are essentially flat through Thursday, according to Barclays. Mr. Hayes says they are inexpensive relative to U.S. Treasury or corporate debt, even after last year's rally.

Munis are often favored by investors who can benefit the most from the tax advantages. Investors typically pay no federal income tax on interest payments, and there is usually no state income tax due on the interest when residents buy bonds issued by their state or its municipalities.

Investors face certain risks with muni bonds, including the threat of default—a threat underscored by Puerto Rico's ongoing struggles with a high debt load and a weak economy, which has pushed down the value of its bonds.

Morningstar, the Chicago-based investment researcher, recommends several muni-bond funds that focus on shorter-term bonds and that charge low fees, including the Vanguard Limited-Term Tax-Exempt Fund, which has assets of \$21 billion and charges annual fees of 0.20%, or \$20 on a \$10,000 investment.

Low fees are key to boosting returns from low-yielding assets such as muni bonds, experts say.

Other options include the Fidelity Limited Term Municipal Income Fund, with \$4 billion in assets and fees of 0.48%.

Intermediate-term muni bonds, which typically mature in five to 12 years, generally offer higher yields but also are more sensitive to changes in interest rates—though not as sensitive as long-term debt.

"Historically, intermediate has been an attractive balance," says Chris Alwine, head of the municipal-bond group at Vanguard Group. Funds that hold intermediate-term bonds tend to "outperform when it comes to interest rates," he says.

Among intermediate-term funds, Morningstar recommends the Vanguard Intermediate-Term Tax-Exempt Fund, with assets of \$43 billion and fees of 0.20%; the Fidelity Intermediate Municipal Income Fund, with assets of \$5.4 billion and fees of 0.36%; and the T. Rowe Price Summit Municipal Intermediate Fund, with assets of \$4.1 billion and fees of 0.5%.

To be sure, buying shorter-term debt can mean giving up some of the potential gains that long-term bonds can enjoy if, for example, the stock market drops sharply.

"Short-term funds tend to have a higher correlation to equities, so you're not getting as much diversification," says Robert Bradley, chief investment officer at NorthLanding Financial Partners, an advisory firm based in Rochester, N.Y. "If the S&P 500 is down 7% in a month, long munis or Treasurys are likely going to rally in that event, and short-term debt is more likely to just hold its value."

For investors willing to accept that trade-off, one way to decide whether to favor short-term or intermediate-term muni bonds is to think about when you will need your principal back, according to Christine Benz, director of personal finance at Morningstar.

An investor who needs the money in the next few years might want to steer clear of intermediateterm funds, she says, because the bonds in the fund portfolio could drop in value if interest rates rise.

If your bonds mature before you need the money, that risk goes away. In that case, she says, you aren't "in the position of guessing what the Fed will do."

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