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High-Yield Muni Fund Plays the Edges.

As investors fled Chicago's debt this year when its ratings were cut to junk, Nuveen Asset Management LLC fund manager John Miller gathered his team of analysts and asked if it was finally time to buy.

It was a typical move by Mr. Miller, who digs around in the corners of the $3.7 trillion municipal-bond market for big bets that might pay off for his High Yield Municipal Bond Fund.

The approach once counted as fringe behavior in a market typically described as dull and safe. But business is booming as the long stretch of interest rates near zero pushes investors into riskier holdings and redefines what it means to be a buyer of bonds.

Investors poured about $9 billion into high-yield municipal-bond funds last year, according to Lipper. Nuveen's High Yield fund has been a big beneficiary, swelling to about $10.6 billion of assets from a peak of around $6 billion before the financial crisis. It is now the sixth-largest municipal-bond fund in the U.S., according to Morningstar Inc.

"It's a reflection of the fact that interest rates have been low for so long," said Howard Cure, director of municipal research at Evercore Wealth Management. "In their search for yield, investors are more willing to buy high-yield paper."

Mr. Miller's willingness to look for winners among bonds most prone to distress and default has produced market-leading returns in two of the past three years. But it is also a strategy that can lead to hefty volatility in times of market stress and outsize losses when investors want their money back.

In 2008, when municipal bonds fell about 2.5%, the High Yield fund dropped 40%. Then the market's risks increased as bond insurance all but vanished, Detroit declared bankruptcy and Puerto Rico began slipping into financial crisis.

"We want to manage risk, but not shy away from risk altogether," said Mr. Miller, who heads a team that manages more than $100 billion.

The municipal-bond market used to be all about shying away from risk. Investors prized protecting wealth over increasing it and bought the debt seeking tax-free income to fund their retirements. Mr. Miller's introduction to it came in 1993, when he worked as a credit analyst at a Chicago firm managing highly rated bonds for wealthy individuals.

In 1996, he joined Nuveen as an analyst and soon was running a new $20 million high yield municipal-bond fund.

One of his big bets was on the Pocahontas Parkway, a nine-mile stretch of highway southeast of Richmond, Va. In 2003 and 2004, he said, he bought parkway bonds that were backed by tolls and had a face value of about $100 million for 80 cents on the dollar. The bonds were under stress, because some drivers were choosing free alternative roads and because the road had a reputation for being haunted.

It was the fund’s largest holding when an Australian company bought the parkway and backed the debt with Treasurys. The bonds went to about 110 cents on the dollar.

Mr. Miller has also poured money into charter schools, which can lose state funding if students leave. Today, his funds own about $1.4 billion in charter-school debt, a big chunk of the roughly $10 billion that has ever been sold in the U.S.

In 2008, Lehman Brothers failed, and clients pulled out hundreds of millions of dollars. Selling the bonds needed to meet those redemptions wasn’t easy. About half of the High Yield fund involved bonds with no ratings at all that wouldn’t mature for years. Mr. Miller had tried to hedge his funds against higher interest rates by betting against Treasurys. But interest rates fell and the price of U.S. government debt rose, amplifying the losses.

“I went out on the road, and it was difficult to be out there, because people were upset about the performance of the High Yield fund,” Mr. Miller said.

That year left the High Yield fund with about $2.8 billion in assets. It has since bounced back. Over five years, its total return of 7.71% was almost double the market’s, counting interest payments and price appreciation, according to Morningstar. Even so, an investor would have made more money over the past decade in an investment-grade municipal-bond fund from Vanguard—and would have paid lower fees and had less anxiety, several financial advisers said.

Mr. Miller says he adjusted the portfolio structure to prevent that kind of volatility from hitting the fund again. He also says he doesn’t court risk for risk’s sake. Unlike other operators of high-yield funds, Mr. Miller was wary early on about junk-rated Puerto Rico, which is in talks to restructure its $72 billion in debt.

But he did take a big swing on American Airlines. In 2012, when the airline went through bankruptcy, he went shopping for the riskiest debt available: $100 million in unsecured bonds issued by cities to build its facilities and paid by fees from the airline. Those bonds, worth pennies on the dollar, surged more than 60% in value two years later when American merged with US Airways. The new company converted the debt to equity, and the fund now holds about $145 million in American Airlines stock, one of its largest holdings.

Chicago, meanwhile, has underfunded its pensions for a generation and sold billions in debt, but Mr. Miller sees no sign of future financial distress. It has a strong business and financial community, many universities and few fiscal problems that couldn’t be solved by raising its relatively low taxes, according to Nuveen research.

The week after the downgrade, Chicago sold about $674 million in bonds at yields approaching 6%—more than 2 percentage points higher than comparably rated bonds.

As the sale opened, Mr. Miller sat in the tip of a triangular room full of traders manning their terminals and started buying.

THE WALL STREET JOURNAL

By AARON KURILOFF

Sept. 22, 2015 8:54 p.m. ET

Write to Aaron Kuriloff at AARON.KURILOFF@wsj.com