Bond Case Briefs

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Municipal Bonds Shine in Bleak Landscape.

Investing in boring bridges and sewers is paying off once again.

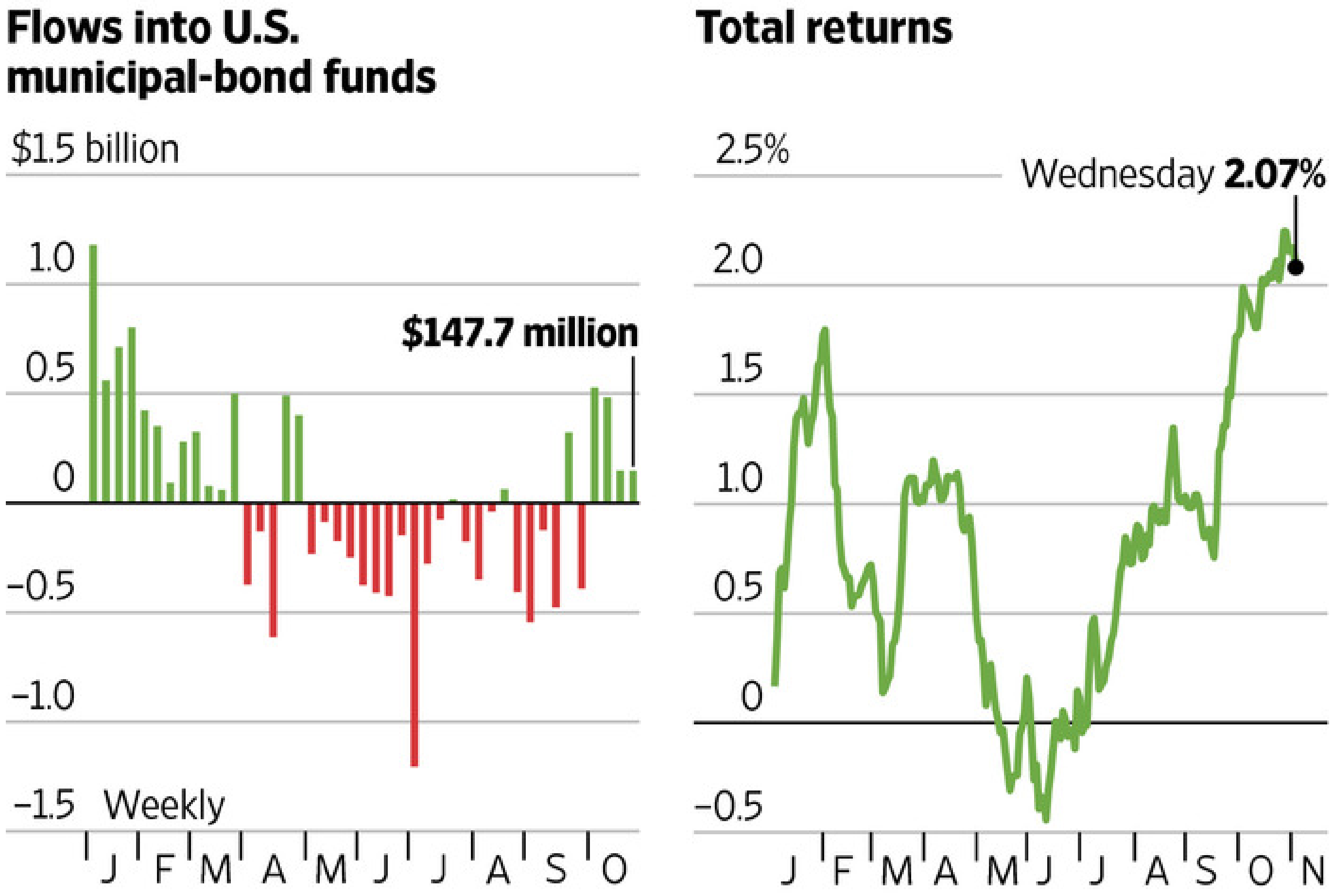
Municipal bonds sold by U.S. state and local governments are returning about 2% this year, according to Barclays PLC data, beating corporate bonds and many other supposedly higher-performing asset classes.

It is the second year of near market-leading returns from a sector typically prized for its low, steady performance. Muni bonds last year posted a total return of 9%, which comprises price appreciation and interest payments, approaching the S&P 500's total return of 14%.

At a time of low returns and high volatility in other markets, the concerns facing muni bonds—including the threat of defaults from Puerto Rico, the U.S. commonwealth that has some $72 billion of debt outstanding—seem relatively manageable to many investors, compared with the risk of a steep pullback in stocks or other riskier assets.

Bouncing Back

Municipal bonds have drawn renewed interest from investors, following a second-half rally that has pushed up returns.



Sources: Lipper (flows) Barclays (returns)

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Municipal bonds are considered nearly as safe as Treasurys because they are backed by tax revenue or fees on critical public services, such as water. The debt also is boosted by interest payments that are typically tax-free, often used to fund peoples' retirements.

Even buyers who can't enjoy the tax breaks are purchasing municipal debt, said David Kotok, chief investment officer at Sarasota, Fla.-based Cumberland Advisors. "If you look around the world, the forces in the advanced economies that would drive interest rates lower, or keep them low, are in place," he said.

Investors have struggled to find better performance.

Total returns in 2015 amount to about 1% for Treasury debt and near-flat returns for highly rated corporate bonds. The S&P 500 has returned 3.9%.

Other market sectors have fared worse. Hedge funds were down an average of about 1.5% in 2015 through September, according to research firm HFR Inc. Commodities are down 17% year to date as measured by the Bloomberg Commodity Index.

The durability in the $3.7 trillion sector persisted even as municipal debt faced challenges throughout the year, including the first default from Puerto Rico and concerns about the financial health of Chicago and states such as Illinois. Investors also spent several months on the sidelines, concerned about possible interest-rate increases earlier in the year.

Those worries diminished when the Federal Reserve didn't move rates, and demand for municipal debt increased. Investors have added money to municipal-bond mutual funds in five of the past six weeks, after withdrawing more than they put in every month from May to September, according to Lipper data. About $2 billion has flowed into municipal-bond mutual funds this year through October.

"Investors began to get more comfortable with the fact that we weren't going to see increased interest rates, which led to more robust demand, and that's helped recent performance," said Peter Hayes, head of municipal bonds at BlackRock Inc., which manages about $111 billion in tax-exempt debt. Mr. Hayes also noted rates have begun to tick up of late.

Investors have returned to munis after a 2013 selloff spurred by fears of a Fed rate increase and another that began after analyst Meredith Whitney predicted widespread defaults in a December 2010 television interview. There were no defaults on debt rated by Moody's Investors Service in 2014, and several analysts said the market includes thousands of diverse municipal entities, many of which have improving resources after the recession.

Meanwhile, the supply of bonds for new borrowing has dwindled, even as state and local governments rushed to take advantage of low rates, according to research firm Municipal Market Analytics. Though issuers have sold almost one-third more debt than during the same period of last year, most refinanced outstanding bonds, constricting the total available.

A supportive foundation leaves municipal bonds poised to benefit as rates increase, said David Hammer, executive vice president and municipal bond portfolio manager at Pacific Investment Management Co. Historically, the debt has outperformed other bonds when interest rates rise, and with state and local finances improving along with the U.S. economy, investors are facing less risk than in recent years, he said. "That creates a pretty attractive backdrop," Mr. Hammer said.

Some analysts said persistent demand has driven up prices, reducing the tax-free income that makes the debt attractive. Many in the market would prefer lower prices and higher yields, which would make it easier to sell bonds or mutual funds, said Matt Fabian, partner at Municipal Market Analytics. Bond yields fall as prices rise.

"You don't buy an income-producing asset if it doesn't produce income," he said.

Still, several investors said the market has provided enough income relative to other assets to shrug off concerns about potential defaults from Puerto Rico, which skipped its first debt payment in August.

Lyle Fitterer, managing director for Wells Fargo Capital Management, which oversees about $39 billion in municipal bonds, said he is still concerned about the impact of possible Puerto Rico defaults. Still, such risks are low marketwide, and once investors consider their tax bill, municipal debt still looks compelling, he said. "Sometimes, superboring can be good," he said.

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