
Muni Bonds: Preparing for Rising Rates.

Income investors have few good options, but munis offer relative safety if rates rise. They provide attractive yields for investors in higher tax brackets.

Income investors have grown accustomed to making the best of a bad situation. Even the pros have grown weary of the will-they-or-won't-they game regarding the Federal Reserve's action on interest rates. Falling stocks and weak global growth only exacerbate a bad situation.

Matt Freund, chief investment officer at USAA Mutual Funds, concedes there are not many great options for income investors. Instead, he says, there are investments with acceptable levels of risk. First on his list: tax-free municipal bonds.

That's not to say munis are terrific buys now. But high-quality munis are a good place to ride out the expected volatility in rates. Investors who stick with top-rated bonds can expect to earn a yield of around 2.4% with little credit risk. That works out to an attractive 4% tax-equivalent yield for high-income investors.

In the last month, Treasury yields have risen about 22 basis points (0.22%), while muni yields inched up just a few basis points. "Munis will be much more defensive in a rising-rate environment than Treasuries are," says Jim Robinson, manager of Robinson Tax Advantaged Income (ticker: ROBAX), a fund made up of closed-end muni funds.

Gary Lasman, a portfolio manager at MFS Investment Management, says as Fed communications continue to indicate a slow and gradual pace of rate hikes, returns should be stable. "You'll earn the coupon, a little less if rates rise modestly," says Lasman. "That should be fine for investors looking for stability and tax-exempt income."

Short-term munis will fall in price if the Fed hikes rates, says Vikram Rai, municipal strategist at Citi Research. But prices of long-term munis might rise. That's what happened during the last period of rate hikes, from 2004 to 2006, as the yield curve flattened and long rates came down, says R.J. Gallo, who heads the muni group at Federated Investors. He believes the yield curve will flatten again, mainly because inflation risks, which drive the long end of the curve, have been muted.

IF THESE EXPERTS ARE WRONG, there's some built-in protection: If muni yields do start to rise, retail investors may start buying more. Gallo says there is an old muni investor saying, "Retail loves a 5% coupon around par." But this time around, he thinks a 4% coupon would bring in retail demand—not that he expects it to get that high anytime soon. Now 30-year triple-A rated munis, callable after 10 years, are issued with yields of about 3.25%.

Citi Research published a report last month arguing that individual investor portfolios are too short in maturity—where yields are lower—and investors should put more money to work at the longer end of the yield curve.

Of course, long-term munis are vulnerable if rates rise more than expected. This is a particular risk for closed-end muni funds. Funds that use leverage to boost yields have even longer durations (a measure of how much a fund could lose if interest rates rise by 1%) and also face higher borrowing costs as rates rise. To hedge against this risk, Robinson uses short positions in Treasury futures, which he calls his fund's "value-add" since that's hard for individual investors to do. But Robinson believes selling in muni closed-end funds will be limited because discounts are already much wider than average—now at the 7.5% level. If discounts get to 9%, he says institutional buyers typically come in.

Investor flight has been a problem for the muni market in the past, even if it doesn't seem imminent now. Freund says muni investors should make sure they won't be forced to sell in a downturn. While munis look good relative to most other income investments (he also thinks some high-yield bonds and dividend-raising stocks offer decent reward relative to risks), investors still need to be cognizant of the risks.

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