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Muni ‘Junk’ Is Seen as Treasure.

As concerns about interest rates, the economy and oil prices spooked junk-bond investors in the fourth quarter, one area of the risky debt market emerged as a relative flight to safety: municipal high-yield bonds.

Since October, nearly $300 million has flowed into the $1.9 billion Market Vectors High-Yield Municipal Index ETF (HYD), according to ETF.com. At the same time, $2.6 billion left the two largest high-yield corporate-debt ETFs.

HYD has a 4.3% yield—5.1% to 7.1% when the effect of reduced taxes are considered—and a 0.35% expense ratio. To get that yield, investors have to swallow exposure to lower-rated municipal credits, including the Chicago Board of Education, Puerto Rico, Jefferson County, Ala., and tobacco bonds across many states.

“Municipal yields are competitive for a risk profile that is fundamentally different” from corporates, says Jeff Weniger, senior strategist at BMO Private Bank in Chicago. “There may be long-term problems in a few areas,” he says, but corporate defaults, in comparison, can cascade across industries, regardless of location.

While 25% of HYD’s portfolio includes investment-grade bonds, nearly all of the holdings are revenue bonds, which depend on specific tolls or fees.

Moreover, HYD’s modified duration is 9.3 years, compared with 4.7 years for iShares National AMT-Free Muni Bond ETF (MUB), which invests only in investment-grade muni bonds. That means HYD is more sensitive to short-term interest-rate changes.

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