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Muni Funds See Most Cash Since '12 on Best Risk-Adjusted Returns.

When it comes to risk-adjusted returns, municipal bonds still can't be beat. And individual investors are taking notice.

The $3.7 trillion municipal market earned about 0.3 percent in March, building on gains of 1.1 percent and 0.1 percent in January and February, Bank of America Merrill Lynch data show. It's just the second time since 2002 that the debt has posted three straight positive months to start the year. While the first-quarter return is merely on par with the average over the past decade, individuals are pouring money into tax-exempt bonds anyway. They've added to municipal bond mutual funds for 26 straight weeks dating back to October, the longest streak since 2012, Lipper US Fund Flows data show.

With tax-exempt interest rates near the lowest since the 1960s, munis don't seem alluring on their own. Rather, they offer a combination of relatively higher yields and lower volatility that's hard to match in the global markets, explaining why individuals continue to favor them, according to investors and analysts at BlackRock Inc., Loop Capital Markets, Oppenheimer & Co. and Vanguard Group Inc. When adjusted for price swings, state and local bonds performed better than many major asset classes in the first quarter, just as they did last year.

"As long as rates stay where they are right now, and you get to earn the coupon, I think retail investors are OK with that," said Chris Mier, chief strategist at Loop Capital Markets in Chicago. "Munis are a good place to hide."

When accounting for risk, as measured by price volatility, the broad municipal market earned 0.95 percent in the first quarter through March 30, data compiled by Bloomberg show. That edges the 0.94 percent return on investment-grade corporate bonds. U.S. Treasuries, high-yield company debt, commodities and the Standard & Poor's 500 index of stocks gained 0.75 percent, 0.36 percent, 0.12 percent and 0.08 percent, respectively.

Last year, munis did even better, returning 2 percent on a risk-adjusted basis while other assets either eked out gains or declined.

U.S. stocks plunged briefly into a correction in August 2015, which may have steered some investors into munis, Mier said. The current streak of inflows, totaling about $22 billion, began in the first week of October.

The S&P 500 recouped most of its losses later last year, only to plunge to the lowest in nearly two years on Feb. 11. The same week the index touched the low, investors added $941 million to muni funds, the fourth-largest inflow of the current stretch.

"Oftentimes we see investors looking in the rear-view mirror — they look at what has done well and buy that," said Chris Alwine, head of munis in Malvern, Pennsylvania, at Vanguard, which oversees $157 billion of the debt. "We've been a bit surprised by the level of inflow."

April will test demand for munis — funds have seen outflows in at least one of the first two weeks of the month each year since 2010, Lipper data show. That's because individuals tend to raise cash ahead of the U.S. tax-filing deadline in mid-April.

Investors may also react to price declines from mid-February to mid-March, which drove benchmark 10-year yields up 0.3 percentage point to 1.87 percent, said Sean Carney, head of municipal strategy at BlackRock in New York.

"Many look at fund flows in the municipal-bond market as a leading indicator, when in all actuality they're a lagging indicator — they lag past performance," said Carney, whose firm oversees $110 billion in munis. "It wouldn't be surprising if we were to begin to see fund flows compress a bit. They've been very strong."

Tax season also has a positive effect for munis: reminding investors how much they pay, and what they could save by earning tax-exempt interest. Including a 3.8 percent levy on the investment income of top earners resulting from the 2010 Patient Protection and Affordable Care Act, the highest federal rate is 43.4 percent.

That means the 1.75 percent yield on benchmark 10-year munis is equivalent to 3.1 percent on a taxable basis for top earners. That compares with 1.77 percent on U.S. Treasuries and exceeds the rate on 10-year bonds from Australia, Canada, China, almost all European countries, New Zealand, South Korea and Thailand, Bloomberg data show.

"People are looking at this external volatility and they want to put their money into something that's more stable and consistent," said Jeffrey Lipton, head of municipal research at Oppenheimer in New York. "If you're within the upper income-tax brackets, and if diversification and preservation of capital is an important investment objective, why wouldn't you put money into munis?"

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