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Slow and Steady Is Sexy Again: Investors Return to Munis.

NEW YORK — Boring? Give me more of that!

The municipal-bond market looks to be regaining its reputation for delivering reliable if unsexy returns, following several big swings since the financial crisis. It's remained sturdy in recent months, even as stocks and other types of bonds have jerked up and down. That has investors, mostly high income earners, once again pouring in dollars in search of safety.

Municipal bonds are issued by states and local governments to raise money to build the school down the street or expand the local sewer system. In exchange for funding projects meant to be good for the community, investors generally do not have to pay federal income taxes on the interest payments they receive. In some cases, they're also exempt from state and local taxes.

The largest municipal bond fund returned 2.9 percent last year, more than the largest stock fund's 0.3 percent. More importantly for twitchy investors, Vanguard's Intermediate-Term Tax-Exempt fund is on pace for its 10th straight month without a loss.

Demand has been strong enough that roughly $16.5 billion has flowed into municipal-bond mutual funds over the last year, according to the Investment Company Institute.

Contrast that with the $73.6 billion that left taxable bond mutual funds, in large part because investors were fleeing high-yield funds on worries about their riskiness. Stock funds had even faster rates of withdrawals.

Just remember that the reason for muni bonds' recent popularity is precisely because they're boring. Don't come in with expectations of getting rich quickly. Yields are low, which cap future returns, and their strong performance last year and so far in 2016 has pushed yields even lower.

"I don't think there's a lot of downside, but the upside is limited too," says Guy Davidson, director of municipal bond management at AllianceBernstein. "Muni funds can offer stability and income in a volatile world, but I don't think you should be preaching for excitement given these yields at the moment."

A DIFFERENT STRUCTURE

Yields are low for muni bonds relative to their history, and they can also be lower than taxable bonds with a similar maturity and credit rating. That's traditionally been the case because muni bonds' income is free of taxes.

Top income earners have a federal tax rate of nearly 40 percent, which means a taxable bond yielding 3 percent would generate the same spending power after taxes as a muni bond yielding just 1.8 percent. Many websites have online calculators that help investors figure out the "tax-equivalent" yield of their bond funds.

That's also why investors hold muni bonds in taxable accounts. If they were in a 401(k) or another tax-deferred account, their tax advantage would be wasted.

PAST SHOCKS

The muni bond market has historically been relatively sleepy. Then the financial crisis hit.

Municipal bond funds held up better than most investments, but the largest category of them still lost an average of 2.3 percent in 2008. Returns rocketed higher the next year, but another shock came in late 2010 and early 2011. That’s when a high-profile prediction for a wave of municipal defaults sent investors running for the exits.

The default wave never materialized, but panic set in again in 2013 when worries spiked that interest rates could rise faster than expected. Since then, the muni bond market has dealt with more scares, like the recent debt crisis in Puerto Rico.

STAYING CHOOSY

It’s not just Puerto Rico that has raised concerns. Investors are worried about Chicago and areas that have big pension obligations. Governments heavily reliant on revenue from the oil industry are also under pressure, following the collapse in the price of crude. The fear is that if local tax revenue craters, it will be difficult for the municipality to pay back investors.

But fund managers say the market sees these as isolated trouble spots. In the rest of the country, tax revenue is on the upswing due to the stronger economy. And many local governments slashed their expenses and held off on issuing debt following the financial crisis.

“Throwing out Chicago and Puerto Rico, muni credit is kind of as good as it’s ever been,” says Nick Venditti, portfolio manager at Thornburg Investment management. “It’s very easy for a muni bond buyer to come into the market and avoid the Chicagos and Puerto Ricos and find more fundamentally strong credits.”

POTENTIAL RISKS

Like any bond fund, a municipal-bond fund will fall in price as interest rates rise. So far, rates have remained low, but most expect them to eventually rise. If it happens slowly enough, the bigger income payments that higher rates would bring could offset price drops.

When assessing the market, muni fund managers also look at how much supply and demand exists for tax-free bonds. Supply hasn’t grown as much as in the past, because local governments have been slow to borrow since the financial crisis.

Managers see the strength of demand as the bigger potential threat to future returns. The municipal-bond market is dominated by individual investors, rather than big institutional investors or hedge funds, and they have shown in the past that they can be quick to sell.

For now, muni bonds’ steady returns mean demand has remained consistent and strong. Managers say they see few reasons for that to change, at least in the near term.

“I am expecting more of the same,” says Regina Shafer, who runs municipal bond funds at USAA. “I think investors appreciate the stable market that municipals bring. We’re steady as she goes.”

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