Bond Case Briefs

Municipal Finance Law Since 1971

A Top Muni Fund's Secret: Buy Tobacco, Stay Clear of Puerto Rico.

One of the best-performing U.S. municipal-bond funds rose to the top with debt backed by a once bankrupt county and cigarette-company payouts at risk as Americans kick the habit. Another driver: It largely steered clear of Puerto Rico.

Money managers Jeffrey Burger and Daniel Barton pushed the Dreyfus High Yield Municipal Bond Fund to a return of 4.5 percent this year, more than any other open-end muni fund that's available to American individual investors, according to data compiled by Bloomberg. The fund, with about $160 million in assets, has gained 8.6 percent over the past year, besting 93 percent of its peers.

The fund has benefited from gains in the riskiest corners of the $3.7 trillion municipal market as investors look for bigger returns while yields hold near a half-century low. With money flowing in and debt sales slowing, some of the lower-rated securities have rallied, including those repaid with money states receive from the 1998 legal settlement with tobacco companies.

"A lot of people have been trying to get very few deals," said Barton, who is based in Boston. "The market is likely to continue at a premium, if not get stronger."

The fund's biggest single holding at the end of March was about $5.8 million worth of New Jersey tobacco bonds due in 2041, with the second $4.2 million of Ohio's that mature in 2047. Its third largest: a $3.9 million block of securities sold by Jefferson County, Alabama, in 2013 as it emerged from the bankruptcy. The Dreyfus fund held about $1 million of debt issued by Puerto Rico, whose growing fiscal crisis led this month to the government's biggest default yet.

The push into tobacco bonds proved prescient. The industry arrested a long-time slump, partly because lower gas prices left consumers with more to spend. Cigarette sales, which determine the size of the legal payments, grew 2 percent last year after declining since 1981, according to a May 2 report by Janney Montgomery Scott LLC. As a result, the securities delivered 17 percent over the past year, more than triple the gain of the broader tax-exempt market, S&P Dow Jones Indices data show.

"Tobacco bonds have taken off thanks to an increase in smoking spurred by lower energy prices," said Burger, who co-manages the fund from Boston at Standish Mellon Asset Management Co.

The Dreyfus fund's investments are scattered over nearly 100 individual securities, which buffers it against risk. The managers declined to comment on specific holdings.

"Diversification is important in the high-yield sector, just as it is in any other kind of investing," said Barton.

The fund's portfolio also included Chicago's wastewater system bonds, private prisons and charter schools in Arizona, and capital appreciation bonds — which delay payments until they mature — that financed California schools and a retirement center.

One criteria the managers weigh heavily: How easy it will be to sell a bond if they want to change course. Recently, the strong demand for high-yield debt — and the diminished pace of new borrowing — has made the market more liquid, they said.

Returns are also being buttressed by the improving finances of state and local governments, which stands in contrast to the high-profile collapse of Puerto Rico. The Caribbean island's long-building strains haven't affected the broader market because investors recognize that its problems are unique.

"You didn't see the contagion in this market that you may have seen in others," said Burger. "Most municipal credit is improving, and we look for bonds that have better credit characteristics."

Bloomberg Business

by Darrell Preston

May 5, 2016 — 2:00 AM PDT Updated on May 5, 2016 — 6:27 AM PDT