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High-Yield Funds With Cash to Burn Chase Tobacco Bonds' 51% Gain.

High-yield municipal bond fund managers have cash to burn. So do American smokers, who have extra money after filling their gas tanks.

The two groups, each in their own way, are driving a rally in the $34 billion tobacco-bond market that's outpacing just about every other investment.

High-yield tobacco securities have surged 10.2 percent in 2016, the most among all segments of the $3.7 trillion municipal market, Barclays Plc data show. That follows gains of 15.8 percent and 19.2 percent in the past two years. The 51 percent return since the start of 2014 beats more than 80 percent of stocks in the S&P 500 Index and close to 90 percent of the Russell 2000 Index of small-cap company shares, data compiled by Bloomberg show.

To explain much of the gain, one needs only to follow the money. Individuals added cash to high-yield muni funds for 100 of the past 122 weeks, lifting their assets to a record $82 billion from $58 billion at the start of 2014, according to data from Morningstar Inc. and Lipper US Fund Flows. With Puerto Rico heading toward an unprecedented restructuring, money managers who once snapped up the island's bonds are now avoiding them, leaving the tobacco securities one of the few available alternatives.

The other side of the rally stems from signs that American smokers are using savings at the gas pump to buy more cigarettes. The shipments backing the debt as part of a 1998 settlement with tobacco companies increased last year by 1.9 percent, the most ever, according to data from the National Association of Attorneys General.

"If you're getting lots of money into a high-yield fund and you've decided that you're not going to buy Puerto Rico, like most people, really tobacco is your only other option," said Craig Brandon, co-director of municipal investments in Boston at Eaton Vance Management, which oversees $32.5 billion of the debt. The uptick in smoking "gives you a credit reason to buy tobacco at a time when you really need a high-yield sector to invest in."

Buying tobacco bonds has long been considered a risky move. Most are rated junk because when governments first sold them more than a decade ago, which gave them advances on money they are set to receive from Reynolds American Inc., Lorillard Inc. and Philip Morris USA, they didn't anticipate how quickly Americans would give up smoking. And the more cigarette sales fall, the longer it will take for governments to collect the payouts.

Moody's Investors Service projects that a 4 percent annual decline in cigarette shipments would cause 80 percent of the bonds to default. From 2007 to 2014, the drop was even bigger: Shipments fell an average of 4.7 percent annually, according to NAAG data.

The decline in oil prices in the second half of 2014 — from over $100 a barrel to about $53 — halted the decline because gasoline fell, too, giving people more disposable income. The national average for a gallon of gas in the U.S. is $2.22, about 40 cents lower than a year ago, according to the American Automobile Association.

Smokers “save more because of lower gas prices and they tend to spend it on cigarettes,” said Vikram Rai, head of muni strategy at Citigroup Inc. While the boost in cigarette shipments “could be a flash in the pan,” he says high-yield investors should consider buying the securities and definitely hold onto those they currently own.

Some of the biggest and most-frequently traded tobacco bonds are at levels not seen since before the financial crisis.

Two of the three largest single tobacco bonds, from Ohio’s Buckeye Tobacco Settlement Financing Authority and California’s Golden State Tobacco Securitization Corp., traded in the past two weeks at about 100 cents on the dollar, the most since February 2008 and August 2007, respectively, data compiled by Bloomberg show. Both have a June 2047 maturity and ratings six steps below investment grade by Moody’s, which projects annual shipment declines of 3 percent would cause them each to default.

“I’m pretty cautious at these levels — there’s been a lot of gains,” said Alan Schankel, a managing director in Philadelphia at Janney Montgomery Scott. “The upside is limited as you approach par, and the downside is there.”

Tobacco-bond returns have also dwarfed other junk asset classes. High-yield corporate bonds and loans returned 4.75 percent since the start of 2014, Barclays data show.

While buying after the rally isn’t the best entry point, the dynamics driving it don’t seem likely to change this year, Citigroup’s Rai said. Even if prices remain steady, the largest tobacco bonds offer investors yields above 5 percent at a time when top-rated munis maturing in 30 years deliver half as much.

“Tobacco bonds are priced properly because we know what the moving parts are; we know how to model that risk,” Rai said. “If you’re content with a 6 or 7 percent return, even if you buy them now, you’ll get that.”

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