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Some Investors Begin to Cool to Hottest U.S. Muni Bonds.

May 26 For more than eight months, investors have poured money into the riskiest U.S. municipal bonds, boosting prices as they dive into anything that can give them fatter yields in a global low-rate environment.

But increasingly, some portfolio managers and analysts are raising concerns about high-yield muni. They are waving red flags about its most notorious borrower, Puerto Rico, but also its best-performing sector, tobacco, and other potentially troublesome areas.

The space should be navigated with "extreme caution," said Citigroup muni strategist Jack Muller.

The sector has ring fenced its most troubled issuers, and investors could be penalized if they get stuck holding bonds that slip into that roped-off territory.

At the start of last year, market sentiment priced about $74 billion of munis in that distressed category, based on Citi's analysis. By this January, the figure doubled to about $150 billion, Muller said.

"You don't want to be part of anything when it does make that transition into the market consensus of distressed," Muller said.

Money has flowed to high-yield muni funds for 33 straight weeks, with nearly $5 billion of inflows so far this year alone. It was the best first quarter for high-yield fund flows in nine years, according to data from Lipper, a Thomson Reuters unit.

Investors are chasing returns. The S&P Municipal Bond High Yield Index has notched 4.02 percent of positive returns this year. Within the sector, a strong performance from tobacco bonds, with returns of 9.05 percent, has offset Puerto Rico's weaker 0.95 percent returns, according to S&P indices.

The outperformance could mask potential landmines. Chicago's Board of Education, for example, sold 28-year bonds in February at about 84 cents on the dollar. The same bonds are now trading above par at 101.5 cents, even though the school district's many challenges remain undiminished.

"The high-yield muni market to me seems to be flashing a caution sign. There's not a lot of great value and opportunity there," said Chad Farrington, manager of Columbia Threadneedle's high-yield municipal fund.

Columbia raised the fund's credit quality while increasing cash and other highly liquid assets to 20 percent of the portfolio, the highest since Farrington began managing the fund seven years ago.

To Nicholos Venditti, a Thornburg Investment Management portfolio manager, Puerto Rico and tobacco bonds are both "garbage."

The two categories make up 60 percent of the Bank of America Merrill Lynch Municipal High Yield

Index.

To buy such bonds now would be “literally buying the weakest credit at the most expensive it’s ever been in history,” Venditti said at a recent media event. He said extremely tight credit spreads meant that investors are not getting enough extra yield for buying riskier bonds.

Only about 3 percent of Thornburg’s Strategic Municipal Income Fund is currently in junk bonds.

For tobacco in particular, the “very, very large outperformance that they’ve had is going to be hard to repeat,” said John Miller, co-head of fixed income for Nuveen Asset Management.

The bonds are sold by state and local governments and backed by money from U.S. tobacco companies under a 1998 legal settlement. The risks on these bonds are known, and most expect them to begin defaulting in several years.

Fitch Ratings said last week it would soon strip its ratings from tobacco bonds. Prices on some tobacco bonds were little changed following Fitch’s announcement.

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