Seeking Yield? Consider Insured Munis.

These distressed bonds from troubled places like Puerto Rico or Atlantic City can return as much as 8% after the tax exemptions.

Buying distressed bonds is hardly the stuff of muni investors' dreams. But with the yield on high-quality intermediate munis down near 1.4%, the opportunity to earn extra income by buying insured bonds from places with weak credit profiles is worth a look.

Consider this: Long-term insured Puerto Rico bonds, the main opportunity for this strategy, yield about 4.5% currently. Given that the interest is exempt from federal, state, and local income taxes, that payment equals a taxable yield of nearly 8% for investors in a top tax bracket.

Insured muni prices have held steady near or above par for years, even as Puerto Rico's finances deteriorated. In contrast, uninsured benchmark Puerto Rico bonds now trade for 67 cents per dollar of par value, reflecting how much of the face amount investors expect to recoup.

Insured bondholders got paid this month even as the commonwealth defaulted on July 1 on almost a billion dollars in interest and principal payments. At a time when munis are expensive relative to Treasuries and yields are at historic lows, "the insured Puerto Rico story still offers value," wrote Cumberland Advisors, which manages $105 million in insured Puerto Rico bonds.

There was a time in the muni market when buying insured bonds was commonplace. The financial crisis changed that. Bond insurers failed or had to restructure, and even the best firms lost their triple-A ratings. Now the leading muni insurers—MBIA's National Public Finance Guarantee and Assured Guaranty—have credit ratings in the mid-to-upper tiers of investment grade. Investors essentially evaluate the underlying bond based on the insurer's rating. That's why insurance doesn't add value for the great majority of muni bonds, which are rated higher than the insurers.

"You need a broken credit for the market to really assign value to the insurance," says Hugh McGuirk, who oversees municipal-bond investing at T. Rowe Price. That's also why there aren't a ton of insured bonds to choose from. Less than 10% of the muni market is insured now, but that number is increasing, according to National.

IT'S NOT JUST PUERTO RICO insured bonds that investors are buying. Chicago Board of Education insured munis trade at a premium to uninsured, and yields are attractive. National points to bonds issued by Atlantic City, N.J.; Chicago; and North Las Vegas as recent examples of insured bond prices holding steady or rising while uninsured bonds fell. Cumberland says long-term insured munis outside Puerto Rico yield about 2.5%.

Buying insured bonds of weak credits requires extra legwork, says financial advisor Richard Daskin of RSD Advisors. Investors need to assess the underlying bond and the ability of the insurance company to pay if the issuer defaults. He is comfortable with both National and Assured and thinks they merit higher ratings from credit agencies.

Other drawbacks: Daskin experienced a few delays in receiving payments on insured bonds when Puerto Rico defaulted earlier this month, mainly due to paperwork snafus when the default occurred just before a holiday weekend. “It was eye-opening as to how insurance really works,” he says. He notes the bonds are not very liquid, so investors should plan to hold them long term.

Mark Taylor, manager of Alpine High Yield Managed Duration Municipal fund (ticker: AAHMX), buys insured munis maturing in under five years. He believes National and Assured can meet their obligations in that period. He owns Puerto Rico bonds maturing in 2020 that yield about 4%.

But this strategy is not for everybody. Greg Steier, head of tax-exempt portfolios at Brown Brothers Harriman, won’t buy munis when he’s not confident of credit quality, even if there is insurance. “At the end of day, the underlying credit has to satisfy our criteria,” he says.

For T. Rowe’s McGuirk, insured bonds are “on the table.” He adds, “There aren’t many other opportunities where you can find yield.”

BARRON’S

By AMEY STONE

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