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Fund Manager Q&A: What Should Muni Bond Investors Do Now?

NEW YORK — The past year has meant a wild ride for investors in municipal bond funds.

Between September 2015 and this past October, municipal bond funds had 54 straight weeks of inflows, with investors pouring some $68 billion into them. Muni fund owners were rewarded handsomely: In the first six months of 2016, the BlackRock Strategic Municipal Opportunities fund returned 4.7 percent, for example. The 10-year yield on the AP Municipal Bond index, which moves inversely to bond prices, hit a low of 1.69 percent in July.

Then the bear came out roaring.

In early October, the flow of dollars into muni funds stalled as bets increased that the Federal Reserve would raise interest rates late this year. Selling accelerated after Donald Trump's surprise victory on expectations that his plans to boost economic growth would hurt the price of bonds. In November alone, investors yanked over $10 billion from muni funds, according to the Investment Company Institute. BlackRock's Strategic Municipal Opportunities fund fell 4.4 percent.

Peter Hayes, co-manager of the $4.7 billion BlackRock Strategic Municipal Opportunities fund, recently talked about the about-face for munis, and how investors can best navigate the current uncertainties. Answers have been edited for length and clarity.

Q: Muni bonds have just undergone an intense sell-off. Do you think it has gone too far?

A: Well, every big sell-off winds up being a good long-term buying opportunity, at some point. It's a question of finding the right entry point.

This sell-off has been so dramatic that it created value in a short amount of time. Municipal bonds are yielding more than Treasurys right now, and last week we began to see some stabilization of the market.

But given the headwinds, I'm not sure we are completely out of the woods yet.

Q: Which headwinds worry you the most?

A: Interest rates continue to be a concern. If rates go higher, that will scare investors from long-term assets.

Q: What about tax rates? Some believe that the Trump administration will slash tax rates for higher earners, which would diminish the value of muni bonds' tax-free income.

A: That's a potential headwind as well, but it's much longer term. I think we need to get past the inauguration and see what the new administration is really most concerned with.

Q: With all the talk of tax reform, some have wondered if the municipal tax exception could

be at risk.

A: We emphatically don't believe that we will lose the muni tax exemption. Taxes are a bit of an overhang to the market, but a lot of that's already been factored into the price of the bonds today.

Q: Sounds like taxes are a wildcard. But it does seem likely that President-elect Trump will try to boost infrastructure spending. How do you think that will impact the muni market?

A: The initial reaction to the infrastructure proposals was that it would be negative, because it would mean more issuance in the muni market. That is usually a headwind for performance, given that we don't know what the demand is going to be.

But if you really look at the Republican proposals, they're talking about an infrastructure bank and private tax credits. That doesn't translate into increased muni issuances.

It's also important to keep in mind that this year, about 60 percent of new issuance was related to issuers that were refinancing their debt.

If rates move higher, refunding will be less attractive. So I don't see the current proposal as we know it today translating into higher issuance in the muni market in 2017, especially if the first half of the year is driven by all this insecurity around tax policy. Altogether, I don't see infrastructure as a big headwind.

Q: So what's the best strategy for investors right now?

If you already own munis, don't sell. The market has already sold off significantly.

If you need a bit of income and want to take a position, shorter-term bonds look cheap. For the most part, stay in the three- to five-year range, where you will be less exposed to a change in tax policy and a potential rise in longer-term interest rates. Because the correction has been so large, those looking for more income might want to put a portion of their money in the 10- to 15-year part of the curve.

Otherwise, I suggest waiting on the sidelines. The severity and size of the move is likely to have scared investors. The next several weeks are very important. If the fund flows continue to be very negative, we have to be cautious. If they stabilize, then I think we can be more confident that the worst is over.

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