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Muni Bonds May Not Be the Reliable Bet They Once Were.

Investors should make sure to better understand the risks, and perhaps adjust their strategy accordingly

Can investors still use municipal-bond funds as core holdings in their taxable accounts?

For a long time, many have done just that—taking advantage of the bonds' big tax benefits, and using their low risk as a haven in times of stock-market turmoil.

But munis aren't looking like such a reliable bet anymore. Since the financial crisis, some big municipalities have defaulted on their obligations, while a number of states, cities and now Puerto Rico are currently facing financial woes. And bankrupt municipalities are increasingly making bondholders scrounge for what's left after paying employee pension funds.

So while it may still be possible to keep a muni fund as a core holding, investors should understand how the asset class has changed.

Price swings in the digital currency led to explosions in trading volume, assets under management and volatility at Bitcoin Investment Trust.

Municipal bonds offer investors interest that's tax-free at the federal level and at most state and local levels, if investors own bonds issued by any government entity within their state of residence.

When deciding whether to buy muni bonds, investors usually make a comparison between the yields of a muni bond and a U.S. Treasury note or bond of similar maturities. The "taxable yield equivalent" to a municipal bond is the municipal bond's yield adjusted for the investor's tax bracket.

So if an investor is hypothetically in a 50% bracket, including both federal and state taxes, a taxable yield twice that of a municipal yield—or a municipal yield half that of a taxable bond—would make two bonds equivalent. In that case, if a highly rated muni bond offered more than half the yield of a comparable U.S. Treasury, an investor could consider the muni bond the better choice in a taxable account.

A changed asset class
For decades, that was a reasonable comparison, and largely all that investors had to consider about munis. The chance of losing an investment was not even an issue: The historical default rate of the roughly $3.8 trillion market with more than 80,000 issuers has been low—0% for AAA-rated bonds and only 0.30% for AA- and A-rated bonds from 1970 through 2009, according to a Moody's study.

Unfortunately, municipal profligacy has begun to result in more high-profile distress and bankruptcy in recent years, including Jefferson County, Ala.; Detroit; Harrisburg, Pa.; Central Falls, R.I.; and Vallejo, San Bernardino and Stockton in California. Now the fate of more than $70 billion that creditors have lent to Puerto Rico is in doubt, as Hurricane Maria battered the island already struggling with manufacturing and population loss.

An updated Moody's study from 2016 notes that the "sector has changed over the past decade and more profound changes may be in the offing. The once-comfortable aphorism that 'munis don't default' is no longer credible, although default rates remain low."

In some cases, investors betting on munis have gotten burned. Recently, Franklin Double Tax Free Income fund merged with Franklin High Yield Tax Free Income fund (FHYVX) after it inflicted significant losses on investors. The fund had more than half its assets in Puerto Rico bonds.

Some analysts warn that many bond issuers are heading into precarious financial situations. In a 2016 research report from PNC Capital Markets, Tom Kozlik argues that around 20% of issuers haven't adjusted their spending to reflect diminished revenue after the financial crisis.

Mr. Kozlik doesn't cite names, but other observers have pointed fingers at issuers at risk.

"Though I'm not warning of an industrywide municipal-bond crisis, I think investors have to think carefully about individual credits and what, exactly, they're investing in," says Nicole Gelinas of the Manhattan Institute think tank. In the case of Chicago, "it's difficult to see, 10 years from now or even sooner, how, exactly, Chicago figures out [its problems with underfunded pensions] without bondholders having to take some sort of hit, as well." (Chicago officials declined to respond to a request for comment.)

And when a municipality goes bankrupt, investors aren't always first in line to recover their money. Stockton and San Bernardino honored their obligations to state-employee pension funds at the expense of bondholders in their bankruptcies. "General obligation" bondholders, once thought to be above revenue bondholders in the case of defaults, aren't necessarily ahead of unions.

Munis aren't Treasurys

Not all municipal-bond experts are pessimistic. Tracy Gordon, a senior fellow at the Urban Institute think tank, says investors shouldn't be alarmed about munis' safety, emphasizing their low historical default rates. "It's unfair to paint the whole sector with a broad brush," she says.

But if investors choose munis as a core holding, many analysts advise using a diversified fund to lessen the risk of issuers defaulting. What's more, investors shouldn't expect the bonds to rally during a stock-market decline, as U.S. Treasurys often do.

That's because munis have become closely tied to the health of state-employee pension funds. If stocks fall and pension funds lose money, the funds often turn to municipalities to make up losses—which makes muni bonds less attractive and hurts muni investors.

Indeed, the Bloomberg Barclays Municipal Index lost nearly 2.5% in 2008 during the stock crash—instead of providing municipal-bond investors with protection. That's hardly catastrophic, but it might not have represented the resilience that the bond investors were expecting. And results might be less benign during the stock market's next wipeout.

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