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Commentary: The Role of U.S. Municipal Debt in Institutional Portfolios

The municipal bond market historically has been retail-oriented, as high-net-worth individuals, particularly those in the highest tax bracket, benefit from the interest income tax-exemption. However, institutional investors, such as banks and insurance companies, have been some of the biggest buyers of municipals over the past several years and now represent approximately 30% of the market. Municipal bonds are issued as tax-exempt and taxable and, while both offer different attributes, each offers a role in institutional portfolios.

An important distinction between tax-exempt and taxable municipals is the traditional buyer base. Tax-exempt municipals traditionally are retail-led while taxable municipals offer attributes compelling to institutional buyers. In our view, recent structural changes have made taxable municipals an attractive strategic option for institutional investors while potentially offering a tactical opportunity in tax-exempt municipals.

Taxable municipals offer compelling attributes to institutional investors

The yield advantage taxable municipals offer relative to tax-exempt counterparts also extends to other fixed-income sectors (Figure 1). The municipal yield profile is attractive and comparable to investment-grade corporate bonds, however municipals maintain a higher quality standing: 92% of U.S. taxable municipals are rated A or better compared to 90% of the U.S. investment-grade corporate market, which is rated A or below (Figure 2). The sector historically exhibits a lower probability of default than U.S. corporates due to the higher quality nature of the taxable municipal market. This is of greater importance, particularly this late in the credit cycle and elevated corporate leverage metrics. Municipals are not guaranteed by the full faith and credit of the U.S. government, however, according to Moody's Investors Service, the 1970-2016 cumulative 10-year average default rate for all rated muni bonds was 0.15% compared to all rated global corporate bonds at 10.29%. Finally, municipals offer the ability to add diversity to a broader portfolio as the volatility is traditionally lower than other components of the market. The 10-year correlations of municipals to other broad U.S. fixed-income and equity sectors exemplify the substantial diversification benefit municipals offer (Figure 3).

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BY JULIO BONILLA · AUGUST 21, 2018 12:00 PM

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