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High Yield Munis Can Be An Equity Hedge, But Understand The Risks.

Summary

- Many investors are looking for ways to hedge against a potential decline in equities, after an impressive run in 2019.
- Municipal bonds are one of my preferred choices for fixed-income exposure, as they have historically low levels of defaults and a low correlation to the equity market.
- High yield munis, however, are less attractive right now. Their spread with investment-grade munis has shrunk, and some bonds in the high-yield sector are struggling to manage debt obligations.

Main Thesis

The purpose of this article is to evaluate the VanEck Vectors High-Yield Municipal Index ETF (HYD) as an investment option at its current market price. As my readers are aware, I have recommended municipal ((muni)) debt in 2019, and that play has been rewarded. However, I have taken a more cautious tone as, similar to equities, valuations have gotten a bit rich and my outlook is less optimistic than when the year started. On that note, I am on the hunt for funds trading at reasonable valuations and which utilize less leverage, which has brought me to HYD, as it is a high-yield muni fund that does not utilize any leverage. While the fund has returned close to 10% this year, and I remain bullish on muni debt, there are a few reasons why I would hesitate to recommend this option. The strength of the high-yield muni sector largely depends on revenue bonds, which offer unique risks to investors that general obligation bonds do not. While this is not necessarily "bad", it is a sector that has been under some short-term pressure. Further, spreads between high-yield munis and investment-grade munis has narrowed recently, suggesting a limited chance of further outperformance from here. Finally, while high-yield munis do offer an attractive way to hedge against downside in the equity market, investment-grade munis offer a similar opportunity.

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