Bond Case Briefs

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Local Finances Are Troubled, but Fund Investors May Still Profit.

High-grade municipal bond portfolios have been among the best places to find income.

Record unemployment and the coronavirus recession are wreaking havoc with the cash-flow prospects for many municipal bond issuers.

State and local governments that rely on income tax and sales tax face sharply lower revenues. And empty roads, airports, stadiums and convention centers mean there is less (or no) revenue to help pay back the bonds that financed those projects.

Yet many municipal bond mutual funds and exchange-traded funds have managed to post positive returns for the first half of the year. After falling 11 percent in the worst of the coronavirus sell-off in March, the market rallied when the Federal Reserve stepped in with support. At this point, the average high-grade intermediate municipal bond fund is back above water for 2020.

The Vanguard Intermediate-Term Tax-Exempt mutual fund gained 2.2 percent for the first half of the year. American Funds' Tax-Exempt Bond Fund of America rose 1.3 percent this year to date. The iShares National Muni Bond E.T.F. gained 2.3%.

Karl Zeile, a co-manager of the Tax-Exempt Bond Fund of America, is telling clients, "This is not a time to run away from municipals. This is a time to step in."

That's not blind optimism.

While bond investors often focus on having a smooth ride, fund managers tend to become excited in periods like this one, when prices have fallen and bargains may be found.

"It's a very inefficient market with a lot of uncertainty, and that breeds opportunities," said Mathew Kiselak a senior portfolio manager for Vanguard's municipal bond team. The $3.9 trillion municipal bond market has a quirky structure: There are around 50,000 issuers, yet no single exchange where trades can be quickly executed.

In the heat of the March sell-off, that inefficiency sent prices plummeting as sellers had difficulty finding, and then enticing, potential buyers. When bond prices dropped, yields rose. Mr. Kiselak says even with the recent rally, high-quality municipal bond yields are still relatively high compared with other bonds', which suggests there is still value to be mined.

While every segment of the municipal bond market other than truly essential services (for water, sewage and electricity) has a near-term revenue headache, some bond issuers could face continuing challenges even once the economy emerges from the coronavirus pandemic.

Nursing homes may have a harder time attracting residents. Small private colleges that rely more on residential-student revenue than large public universities face a financial hit if online learning becomes more mainstream. And it’s not clear how soon arenas, stadiums and convention centers will reopen, or if the seats will be filled.

But most bonds should be just fine, fund managers say. “The bulk of the market is very healthy,” said Peter Hayes, head of municipal bonds at BlackRock.

Of the roughly $3 trillion in bonds that have been assigned credit ratings, more than 90 percent are high-grade issues rated AAA, AA, A or BBB. And less than 10 percent of investment-grade municipal bonds are sitting at the lowest rung of BBB. For corporate bonds, more than 50 percent of the high-grade market is rated BBB.

Highly rated municipal bond issuers typically have enough cash set aside to cover at least a year’s worth of their obligations to their investors. And for so-called revenue bonds — those whose payment streams rely on revenue from specific projects, like toll roads or stadiums — reserves are often even deeper.

That helps to ensure timely payments in the near future, even if their revenue is scarce and Congress does not step in with help for states and cities, many of which are already projecting budget shortfalls. Longer term, absent federal aid, state and local governments would need to consider raising taxes, reducing services and cutting payrolls to cover bills, including municipal bond payments.

Amid the uncertainty, high-grade municipal bonds offer income investors yields that are relatively high. For example, the average yield for a AAA-rated 10-year municipal bond is 0.9 percent, compared with 0.67 percent for a comparable Treasury note. On top of that, interest on municipal bonds is exempt from federal tax, and bonds issued within your state of residence may also be exempt from state and local income tax.

Just counting the effects of the federal tax exemption, if you’re in the 24 percent federal tax bracket, the 1.4 percent current yield on the Vanguard Intermediate-Term Tax-Exempt fund is equivalent to a yield of 1.84 percent in a taxable bond fund (assuming, of course, that neither is held in a tax-sheltered account). For investors in the 35 percent federal tax bracket, the yield is the equivalent to a taxable yield of 2.2 percent The average current yield for core bond funds (whose income is taxable) is 1.4 percent.

If that yield advantage appeals, it bears repeating that the coming months may be rocky.

Mr. Hayes cautioned that even with a reopening of the economy, municipal revenues will “only be at a percentage of what they were pre-Covid.” Even if a vaccine arrives, people may not spend as much, rely on public transportation with the same gusto, or drive or fly as much, or flock to stadiums, arenas and convention centers.

Moreover, some states and cities that issued high volumes of bonds already had severe budget problems before the crisis: Illinois and New Jersey had many bonds rated BBB, the lowest rung of investment grade before the coronavirus. These and other states may find it harder to dig out of this recession.

As downgrades emerge, Mr. Hayes says “headline risk” may shake up the market. When one issuer falters, he said, “investors begin to worry about the overall health of the market, and it becomes a contagion and there is a sell-off.”

But remember that after such sell-offs in the past (see: Puerto Rico, Detroit), there was no lasting impact on the broader market. “Those usually end up being good long- term buying opportunities,” said Mr. Hayes.

There is already opportunity to find value despite the headlines, many managers say.

Mr. Kiselak at Vanguard says that while nursing homes may face a rough road because of coronavirus-related deaths, another type of institution, known as continuing care retirement communities, have not had such problems, but their bonds have been hammered as if they did.

He said the Vanguard municipal bond team is also finding value in the bonds of single-site health care centers that do not have the same challenges as “massive systems that were in epicenters,” where coronavirus costs rose and revenue fell as nonessential procedures were closed.

That same nuanced credit-by-credit analysis is why the Tax-Exempt Bond Fund of America has more than 10 percent of its assets invested in issues from the State of Illinois and municipalities including Chicago, despite broad financial problems in the state and some of its cities.

Mr. Zeile said most of the fund’s stake was invested in revenue bonds “that are unnecessarily tarred with the same concerns” as bonds from Illinois that depend on tax collections, which are referred to as general obligation bonds.

A revenue bond for an Illinois toll road, or for O’Hare or Midway Airport, pays back investors from money earned when people drive on those roads and pass through those airports. They aren’t dependent on direct government tax collections. Yet the yields for some Illinois and Chicago revenue bonds are higher now simply because of the implied guilt by association with general obligation issues.

In the current market, the embedded diversification of a fund or E.T.F. is especially valuable. “If you get an issuer that decides to go through some type of restructuring, in a fully diversified portfolio, the overall impact will be pretty minimal,” Mr. Hayes said.

Downgrades are more likely than outright bankruptcies. According to Moody’s Investor Services, from 1970 through 2018, the average rolling five-year default rate for rated municipal bonds was 0.09 percent, compared to 6.6 percent for corporate bonds.

The nation’s fiscal problems imply that the value of the tax exemption on municipal bond income isn’t likely to wane.

“With these deficits we’re running up, taxes aren’t going down,” Mr. Hayes said. “Who knows if they might go up — that’s probably an election outcome decision — but they aren’t going down for sure.”

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By Carla Fried

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