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How To Navigate The Rocky Municipal Bond Market.

The coronavirus shock impacted all asset classes, including the generally calm world of municipal bonds.

Broad-based municipal bond exchange-traded funds such as the SPDR Nuveen Bloomberg Barclays Municipal Bond ETF (TFI) experienced plunging bond prices while yields on the highest quality issues surged to more than three times U.S. Treasuries with similar maturities.

The onset of the pandemic did something else, too: It spurred more issuer borrowing.

State and local governments scrambled to raise more capital by issuing municipal bonds to the tune of a 31.3% year-over-year increase as of last year's third quarter, according to the Securities Industry and Financial Markets Association. Meanwhile, the pandemic added a litany of unexpected costs.

With just over \$20 billion, the iShares National Muni Bond ETF (MUB) is the largest municipal bond ETF by assets. The Vanguard Tax-Exempt Bond ETF (VTEB) and SPDR Nuveen Bloomberg Barclays Short Term Municipal Bond ETF (SHM), with \$10.6 billion and \$4.4 billion respectively, are next in line.

MUB carries an SEC yield of just 0.86%, and roughly 41% of the portfolio is in California and New York muni bonds. The fund has gained 4.3% during the past year.

Bonds backed by airports, public transit systems, stadiums and universities have been among the hardest hit municipal bond categories. Also, jurisdictions that rely heavily on tourist spending have been slammed compared to areas relying on residential property taxes.

For yield seekers, the VanEck Vectors High Yield Muni ETF (HYD) offers a higher yield for financial advisors with clients who are willing to take higher credit risk. HYD carries an SEC yield of 3.09%, and 74.6% of the portfolio contains bonds that carry a non-investment grade rating or aren't rated at all. The portfolio's remaining portion holds investment grade debt with a BBB rating or better.

It's worth noting municipal bonds are not included in widely held broad-market bond funds like the iShares Core U.S. Aggregate Bond ETF (AGG) or Vanguard Total Bond Market ETF (BND). Investors seeking broader fixed-income diversification beyond corporate and U.S. government debt can add a broadly diversified muni bond ETF to complete their fixed-income exposure.

From an asset allocation perspective, municipal bonds are best held in taxable accounts like an individual or joint brokerage account that can reap the benefits of tax-free income.

For clients who are already in or approaching retirement, be sure they understand the tax ramifications of municipal bond income on their Social Security taxes. While muni bond income is free from federal tax and state taxes under certain conditions, it's still counted as provisional income by the IRS.

Provisional income is the amount of income generated that the IRS keeps track of to determine how much a person's Social Security gets taxed. Things that count as provisional income include any 1099 or interest from investments held in taxable accounts, one-half of Social Security income, rental income, pension income, employment income and required minimum distributions.

These numbers can add up pretty fast. And if they surpass \$34,000 for single filers or \$44,000 for married couples, up to 85% of Social Security income gets taxed.

The municipal bond market can be perilous, particularly for those who invest in it via single bond issuers in troubled jurisdictions or sectors. For example, states with mounting liabilities may be forced to choose between paying bondholders or pension retirees. ☐☐This is all the more reason to encourage clients who want to invest in muni bonds to do so in a diversified and mindful way.

FINANCIAL ADVISOR

JANUARY 14, 2021 • RON DELEGGE

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