Bond Case Briefs

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Future Returns: Navigating the Municipal Bond Market.

The prospect of higher taxes has fueled interest in muni cipal bonds since state elections in Georgia assured Democrats of a slim majority in Congress at the beginning of the year.

That's because municipal bonds allow investors to earn tax-free income. But the benefits of owning the highest quality of these tax-free securities relative to Treasuries or investment-grade corporate bonds have diminished as the rush to munis has pushed prices higher, and yields lower.

The yield-to-worst (the potential lowest yield for a security) of the S&P Municipal Bond Index was only 1.03% on Monday, slightly above a low of 0.92% hit on July 27 this year. By comparison, the U.S. 10-year Treasury closed Monday at a yield of 1.36%

But high prices, and low yields, haven't quashed investor interest in munis. Estimated net cash flows into municipal bond mutual funds and exchange-traded funds reached US$79.25 billion through the end of August this year compared with US$15.73 billion in the same period a year ago, according to Refinitiv Lipper data. Those are the largest inflow totals for municipal bonds on record, according to the firm, a unit of the London Stock Exchange Group.

"There's only been one or two weeks over the last 60 that we haven't had positive cash flows into municipal bond funds," says John Flahive, head of fixed income investments at BNY Mellon Wealth Management.

Penta recently spoke with Flahive about how wealthy investors should approach the municipal bond market amid low interest rates throughout the world of fixed income.

A Rapidly Declining Ratio

Before the pandemic, the yield on 10-year triple-A-rated municipal bonds was about 85% to 90% of the 10-year Treasury yield. For investors in a 40% tax bracket, the taxable-equivalent yield on those municipal securities would be 0.30-0.50 of a percentage point higher (depending on the yield of the security at the time), Flahive says.

But prices of municipal bonds tanked, and yields rose, in the first few months of 2020 as investors feared pandemic-related lockdowns would cause state and local governments to run into financial difficulties. That would mean they could have trouble making bond payments to investors.

As a result, yields on muni bonds rose to nearly four times comparable Treasuries by the end of March 2020, according to research from Brookings.

But interventions by the Federal Reserve during the height of the crisis quickly stemmed fears. By the time the pandemic-related eligibility of municipal securities for the Fed's Commercial Paper Funding Facility and for the Money Market Mutual Fund Liquidity Facility expired on March 31, muni rates had fallen to about 50% of comparable Treasuries, Brookings researchers wrote in an Aug. 31 post.

As Flahive noted in a mid-year report on the bond markets, the yield on 30-year triple-A rated municipal bonds rose just 0.07 percentage point in the first half of this year compared with a 0.47 percentage point gain in 30-year Treasury yields.

The relative after-tax advantage of munis, as a result, was historically low on all maturities as of the first half. Today, the tax-equivalent yield differential between munis and Treasuries is so slim that in some cases it doesn't exist at all, Flahive says.

Total returns for munis have also been modest. The US$14 billion Vanguard Tax-Exempt Bond fund, a national intermediate municipal bond fund, returned 1.32% through Monday, Sept. 13, compared to 4.98% in 2020 and 7.45% in 2019, according to Morningstar.

The credit outlook for municipal securities, meanwhile, "is as favorable as we can recall" as a result of federal fiscal stimulus during the pandemic, Flahive said in the mid-year report. While that stimulus swelled general fund balances, he cautioned that spending budgets by these municipalities will expand, "which could make it more difficult to manage during an economic downturn."

Still Worth Owning

For wealthy investors, the tax advantages of municipal bonds mean the securities are worth buying compared with taxable securities of similar credit quality and with durations of more than five years.

More important for investors, however, is to have a diversified fixed-income portfolio. According to Flahive, investors should even consider giving up some after-tax yield to include taxable bonds among their holdings.

"There's nothing wrong with taking on some corporates, and for those who can take on some risk, there's nothing wrong [with having] exposure to high-yield, floating-rate high-yield, and maybe even emerging market debt," he says.

Sticking With Bonds

Even with rates low across the board, BNY Mellon says investors, generally, should own bonds—albeit a judicious amount. While a generic, moderate-risk portfolio might typically call for 60% in stocks and 40% in bonds (taxable and tax-free), for instance, the wealth manager's high-level recommendation is now for something less than 30% in fixed income, Flahive says.

Of that approximate 30% allocation, most should be in "core" securities, such as intermediate municipal bonds. Generally, this allocation should include about 80% in state-issued municipal securities (for those who live in states with good bond ratings, such as New York or California), and about 20% in national bonds. The portfolio should be diversified between revenue bonds (used to fund specific projects) and general obligation bonds.

Another 6% or so of the total fixed-income allocation could then be in riskier, higher-yielding securities, including opportunistic municipal bond strategies, he says.

"You are probably better off following a diversified fixed-income approach even though you might be taking more volatility asset class by asset class, [because] at least it's not just one asset class," Flahive says.

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