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High-Yield Muni Bonds: Risk With Plenty of Tax-Free Rewards.

Historically, the municipal bond market has been a steady-eddy performer for many investors. Thanks to the fact that they are free from Federal taxes, and in some instances state and local taxes as well, munis are often seen as a way for higher income or high-tax-bracket investors to get much-needed income. Add in their relatively low default rates and it's easy to see why munis form the backbone of many investors' taxable accounts.

But not all munis are "boring" and steady-eddy; some can even add a bit of spice to portfolios.

High-yield or junk municipal bonds are just such a security. Featuring low correlation to other bonds and tax-equivalent yields close to 9%, the rewards may outweigh the risks. For investors, adding a swath of high-yield munis to a portfolio could make a ton of sense.

The Other Side of the Tracks

Most investors are familiar with investment-grade municipal bonds, and the bulk of the \$4 trillion municipal bond market sits firmly in this category. Munis are issued by state and local governments to run their day-to-day operations, raise money for essential services or build a non-revenue generating project like a park or painting a mural downtown. These are general obligation bonds (GOs) and, once issued, they go into the state or local government's coffers. And because GOs are backed by taxes – and the state/local government's ability to raise those taxes – many munis fall under the investment-grade banner.

But not all munis are investment grade. Some carry more risk and fall within the high-yield or junk category. For starters, not all local governments have stable finances – be it from poor economic conditions or too much issued debt overall, cities and local governments could have lower credit ratings.

The other form of high-yield muni debt, and also the largest category, is so-called revenue-backed and project bonds. These are projects that have "an element of essential service that is financially independent from the city, county or state they serve," as defined by investment manager and muni specialist Nuveen. For example, a sports stadium, a public hospital, or light-rail system.

These munis and their potential for repayment are driven by the revenues generated by the project. Tobacco settlement bonds often fall under the high-yield category as well. Because of this, project bonds will often have lower credit ratings than the underlying state/local issuer. Thus, they pay higher yields.

Some Risk, But Plenty of Rewards

As expected, project-tied and high-yield munis have a higher default rate than their tax-backed investment-grade cousins. According to Moody's, 6.94% of all high-yield municipal bonds defaulted within ten years of their issuance between 1970 and 2021. This contrasts to only 0.9% of investment-

grade municipal bonds during that time. The kicker is that the default rate for high-yield munis is much less than corporate junk bonds. Nearly 30% of corporate junk bonds defaulted during the same time period.

On the back of lower defaults versus regular junk bonds, you get a similar yield profile. Historically, high-yield munis have offered a similar tax-equivalent yield to those of junk bonds, particularly for those investors in higher tax brackets. For someone in the highest tax bracket, the 5.45% current yield on high-yield munis is roughly equal to the 9% on regular junk bonds.

Secondly, high-yield munis offer low correlation to junk bonds and other high-yield debt securities. According to Nuveen, high-yield munis have just a 0.5 correlation to junk bonds, a 0.42 correlation to the broader investment-grade bond market, and only a 0.34 correlation to mortgage-backed bonds. As for stocks, they have just a 0.28 correlation to the S&P 500. These low correlations provide plenty of diversification benefits.

Finally, high-yield munis have been pretty good on the total returns front as well. Over the last decade, the sector has managed to produce a 6.54% annual return for someone in the 32% tax bracket. That's not too shabby for a fixed income investment.

Adding a Dose of High-Yield Munis

Now, there is one caveat with regards to high-yield munis, and that is the so-called alternative minimum tax (AMT). Some high-yield munis will qualify for the tax system, with 2017 tax rules raising the AMT threshold to \$1,079,800 for 2023 for married couples filing jointly. As a result, that higher threshold leaves regular investors immune to AMT.

With the benefits, high-yield munis could be a great portfolio addition. Just like regular munis, buying individual bonds can be a daunting task. So, funds and ETFs are the answer.

For index fund seekers, the SPDR Nuveen Bloomberg Barclays High Yield Municipal Bond ETF (HYMB) and VanEck Vectors High Yield Municipal Index ETF (HYD) are the two of largest funds in the category and offer exposure to hundreds of different high-yield muni bonds. With yields north of 5% and low costs, they could be all investors need.

However, the high-yield space is one area in which active management really makes a difference. Analyzing the revenue trends that affect payment of these bonds can unearth opportunities. Funds like the Lord Abbett High Yield Municipal Bond Fund (HYMAX) or PIMCO High Yield Municipal Bond Fund (PHMIX) could make sector-beating options for fixed income investors.

All in all, high-yield munis represent an under-utilized bond variety that can be used to boost income on an after-tax basis. While there is risk, the rewards are numerous.

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