CURRENT YIELD

The Case for High-Yield Municipal Bond Funds

They're lower-risk than their corporate counterparts, and their tax advantages now look more secure.

By AMEY STONE
April 8, 2017 12:21 a.m. ET

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Investors in search of better yields—but who want to avoid taking too much risk—should consider an often-misunderstood sector: high-yield municipal bonds.

The funds that invest in these low-rated—or unrated—tax-advantaged bonds are staging a comeback after getting slammed after the November election.

So far this year, high-yield muni funds are up 2.7%, compared with 1.66% for long-term national muni funds and 2.48% for high-yield corporate-bond funds, according to Morningstar.

While high-yield muni funds do take more credit risk than investment-grade munis, they have a much lower default risk than their similarly rated corporate-bond counterparts. Yet their yields, at about 5%, are close, says Richard Daskin of RSD Advisors. "On a tax-equivalent basis, you are really way ahead of the game," he adds.

High-yield muni funds have long average maturities, and thus are subject to interest-rate risk—but they don't correlate with Treasuries as much as investment-grade munis, adding some diversification. Plus, the odds of interest rates spiking this year are lower, now that the Trump administration's plans to add economic stimulus are getting bogged down in Washington, and some economic data, like Friday's March payrolls report, are pointing to slower growth. Prospects for major tax cuts—one reason munis sold off last fall—are fading.

"This year is unfolding a little more favorably than most projections for the asset class," says John Miller, portfolio manager of the Nuveen High Yield Municipal Bond fund (ticker: NHMAX), which is up 3.37% this year and 7%, on average, over the past five years. "Sweeping changes to taxes and budgeting aren't going to be as easily accomplished as many assumed."

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Closed-end high-yield muni funds, which use leverage, typically offer higher yields and are cheaper than usual. These funds, which trade on exchanges, can be bought at a discount when out of favor, which is the case now. For

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example, Pioneer Municipal High Income Advantage Trust (MAV) is trading at a 7% discount, while for the past three years it has traded at an average premium of 10.5%. Its yield is 5.16%.

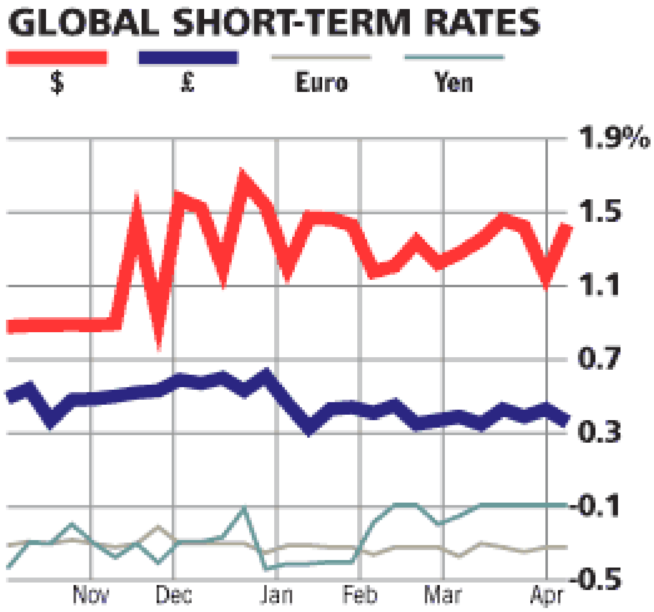
Like other closed-end muni funds, this Pioneer fund has had to cut its distributions recently, as the rise in short-term interest rates increased the cost of borrowing, and its high-coupon holdings were called, requiring the manager to buy new bonds at lower rates. Both trends are likely to continue, which explains the discounts.

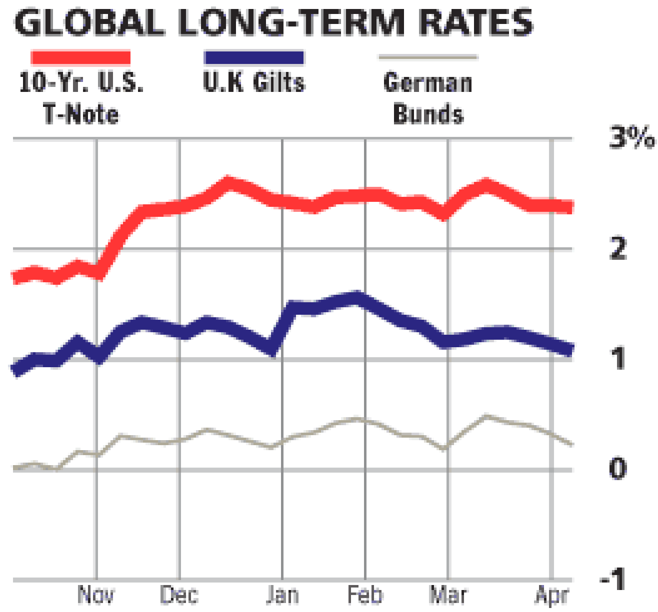
“The yields aren’t necessarily sustainable, but if you’re buying them at a discount, and they are liquid, I think they are attractive,” says Jay Hatfield, CEO of Infrastructure Capital, who has been adding the funds to some portfolios lately.

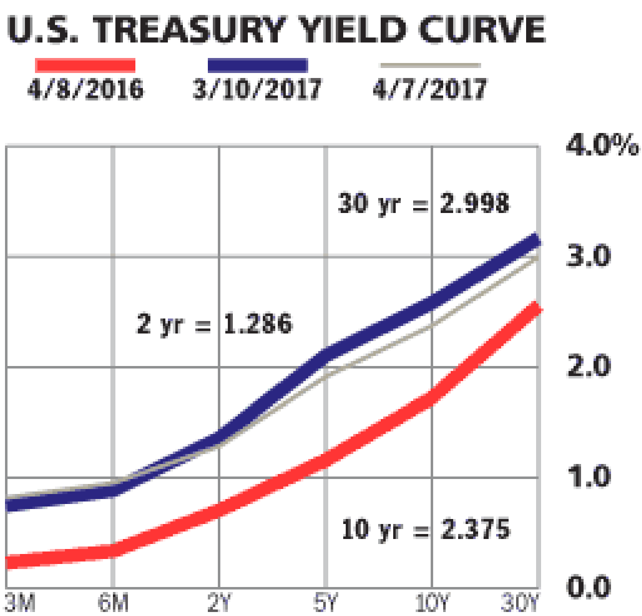
FOR LONG-TERM INVESTORS who want to minimize the risk of needing to sell at a discount, Alexander Reiss, a closed-end-fund analyst at Stifel, recommends Eaton Vance Municipal Income 2028 Term Trust (ETX). It has a 4.3% yield, is selling at a 3% discount, and matures at par in 11 years. “You have a good idea where you’ll land,” says Reiss. The fund’s weighted average credit rating is triple-B-minus, just one notch into investment grade.

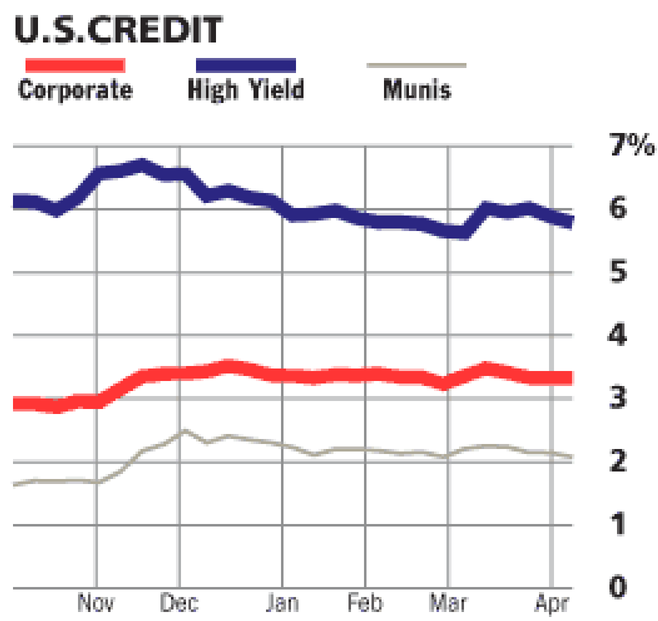
“We like high-yield tax-exempt, but it has had quite a run” in recent years, says Jim Robinson of Robinson Capital. He owns Nuveen AMT-Free Quality Municipal Income (NEA), which has more exposure to high-yield than the average muni closed-end fund.

RSD’s Daskin thinks that exchange-traded funds—such as VanEck Vectors High-Yield Municipal Index (HYD), which yields 4.4%—are a good option now. The VanEck fund is liquid, has low fees and no leverage, and about 30% of its holdings are rated investment-grade. “I haven’t felt the need to reach for yield in this space” by turning to closed-end funds, says Daskin.









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