Municipal Bonds Attractive Despite Lower Yields

Jim Murphy

Municipal bonds have provided stellar returns and attracted increasing investor interest over the past year. The Barclays Municipal Bond Index had a total return of 9.9% for the 12 months ended June 30, 2012, and muni yields have been exceeding Treasury yields this year. Jim Murphy, manager of the Tax-Free High Yield Fund, provides his perspective on various aspects of this sector and its outlook.

Performance: Last year's dire prognostications of heavy defaults in the market proved overblown, despite the largest municipal bankruptcy in U.S. history in Jefferson County, Alabama. Also, we have seen tremendous investor interest despite relatively low yields, while new muni bond supply has been restrained. Muni issuance last year hit the lowest level in a decade [$295 billion] and remained sluggish earlier this year. State and local governments are now being forced to live within their means. So with increased demand and less supply, rates have declined and prices have gone up.

Yields: In absolute terms it's hard to get excited about investing in yields of around 4%, but yields have declined significantly among all fixed income sectors. So in a relative sense, munis are certainly attractive for investors in high or medium tax brackets. A 4.5% muni yield would equate to a taxable yield of 6.9% for someone in the top tax bracket. Muni yields have actually been exceeding Treasury yields recently and look attractive versus corporate bonds as well.

Creditworthiness: The municipal market overall is a very high-quality market. Historically, the default rate has been less than 1%. That was the case last year and should be again this year. That said, budgets for state and local governments remain tight. Tax revenues are just now returning to pre-financial crisis levels in many places. However, cutbacks in state support and persisting downward pressure on property tax revenues could keep local municipal issuers vulnerable.

States and localities have been forced to downsize, and, in many cases, these tough choices are being made. Many states deserve high credit ratings, and we don't see a near-term threat to their ability to continue servicing their outstanding debts.

But the credit landscape has definitely changed, and this is no longer a do-it-yourself market for the individual investor; fundamental research is critical.

Portfolio Strategy: Our fund has been significantly overweight in health care-related revenue bonds, such as those issued by hospitals and continuing care retirement communities. They account for about 29% of the portfolio. Such bonds have provided solid returns despite concerns about reimbursement pressure on hospitals at the state and federal level.

Yields in this sector are attractive due to uncertainty in the health care industry. And many hospital issuers have improved their operating performance and balance sheets and delivered good bottom-line results.

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It's also worth noting that general obligation bonds, which those entities issue, account for only about 30% of the market. It is actually a bit of a misnomer even to refer to our market as a high yield market. It's really more of a higher-yielding market. Noninvestment-grade bonds represent, at most, about 10% of the total market.

We have about a third of our portfolio in bonds rated A or better, about a third in BBB, and a third below investment grade.

Virtually the entire fund is invested in tax-free revenue bonds funded by specific projects—essential services such as utilities and water and sewer systems, for instance. There is a much more durable revenue stream backing those bonds.

We also favor essential service transportation bonds for infrastructure projects such as airports, toll roads, and port authority bonds. Publicly financed infrastructure projects tend to be very solid credits that generate durable revenue streams.

In addition, these projects often benefit from very limited or no competition—a distinct difference compared with private sector companies. You don't see many competing airports or toll roads. This enhances the creditworthiness of the bonds, and they tend to trade very well.

We also have a fifth of the fund invested in tax-exempt, corporate-backed revenue bonds issued for industrial development or pollution control projects. We collaborate with our corporate and taxable high yield analysts to find the best credits in these areas that also offer attractive yields.

Risks: There always is credit risk, but, as noted, this is a very high-quality market, and we have a large team of credit analysts. Research has always been the lifeblood of what we do in managing this portfolio, even when it was not fashionable or even necessary when we had insured bonds. It takes a lot for a bond to get into our portfolio, and they've been vetted by several people. We also maintain a very disciplined sell strategy.

The municipal bond market is a $3.7 trillion market, but it is composed of many small, local issuers, so it's a very inefficient market. Our research capacity enables us to find a lot of value in these smaller deals.

The other risk to keep in mind, especially with Treasury and muni yields near historical lows, is a rise in interest rates that causes declines in prices. There is no escaping interest rate risk when you invest in fixed income.

The municipal yield curve is at historically steep levels, so we continue to favor longer-term maturities. However, our interest rate sensitivity is fairly muted because we have favored more defensive structures and largely avoided the use of leverage.

The duration or interest rate sensitivity in our fund is about six years. That suggests that if rates rose by one percentage point, you might lose about 6% in principal. But that loss would be cushioned by the yield earned on the bonds.

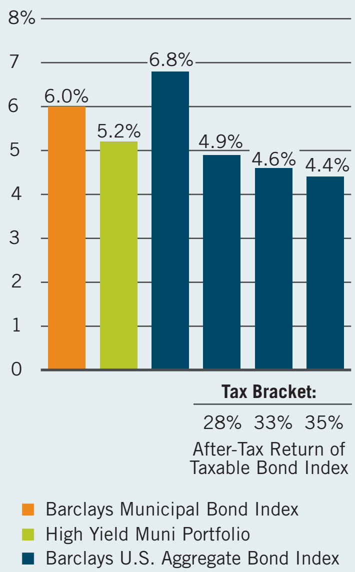
Also, if rates are rising, it probably will reflect an improving economy, which should tighten yield spreads among credit sectors. That tends to provide a buffer on the principal return.

Market Outlook: Muni returns this year may moderate compared with 2011, with the credit and economic environment for municipalities still challenging. Most of the return should come from yield rather than price changes. If the economy slides back into recession—which we do not expect—state and local governments will face even tougher challenges. Their longer-term liabilities, such as pension benefits and health care costs, are a growing concern.

Near term, we expect to see slow and steady growth in the economy, with the Federal Reserve continuing its holding pattern on rates. Steady economic growth and low inflation are keys to sustaining muni performance. So if rates stay low for the next year or two, munis should do just fine.

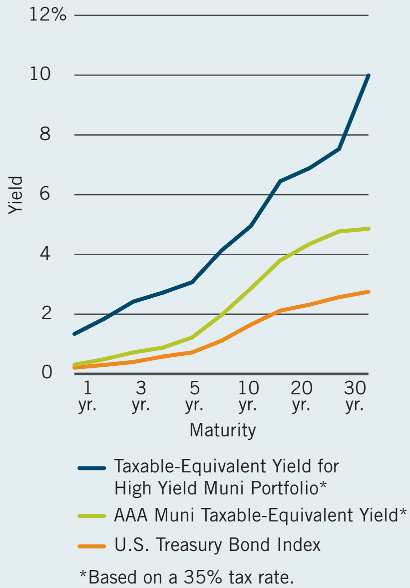
Municipal vs. Taxable Bond Returns

Total Return: Five Years Ended 6/30/12



Municipal vs. Taxable Bond Yields

(as of June 30, 2012)



The after-tax returns of the Barclays U.S. Aggregate Bond Index (left chart), composed of taxable corporate and government bonds, are based on taxing the income generated by the index each year by the tax rate shown. It does not take into account state income taxes. Capital gains taxes also are not figured in because the example assumes no shares in the index are sold over the five-year period. Since only interest is being taxed in this example, the pretax and after-tax returns for the municipal bond index are the same.

For the chart comparing current muni and taxable bond yields at various maturities (right chart), the taxable-equivalent yield for munis assumes a 35% federal tax rate and no state taxes. The chart shows the taxable-equivalent yield for a AAA municipal bond (middle line) and for a high yield muni portfolio (top line). (The taxable-equivalent yield of a tax-free security is calculated by dividing the tax-free yield by one minus the investor's marginal tax rate, which might combine the investor's federal and state tax rates.) State taxes could apply to out-of-state issued municipal bonds. Interest earned on U.S. Treasury bonds is exempt from state taxation.

Note: The high yield muni portfolio consists of 65% investment-grade bonds and 35% noninvestment-grade bonds, which is representative of the high yield municipal bond market.

Sources: T. Rowe Price Associates, Federal Reserve Bank of New York, and Municipal Market Data.