The Case for High-Yield Munis

Some investors may be surprised at the array of potential benefits the asset class has to offer.

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Dan Solender, Lord Abbett Partner and Director of Municipal Bonds, recently highlighted several positive factors supporting the municipal bond market. In this Market View, we focus on one area of that market: high-yield municipals. Municipal bonds are rarely in the headlines of the popular media (and when they are, it is often with a negative connotation), so some investors may be surprised at the array of potential advantages the asset class has to offer.

Historically Strong Returns

Given the well-publicized troubles of certain municipal issuers such as Puerto Rico and Detroit in recent years, many investors might not be aware that the Bloomberg Barclays Municipal Bond Index has outperformed the Bloomberg Barclays U.S. Aggregate Bond Index (the U.S. Aggregate Index), representing the broad investment-grade taxable U.S. bond market, over the trailing one-, three-, five-, and 10-year periods (as of March 12, 2019) as shown in Chart 1.

Chart 1. High-Yield Munis Historically Have Offered Strong Returns Relative to Other Bond Categories

Returns over the trailing one-, three-, five-, and 10-year periods (as of March 12, 2019)

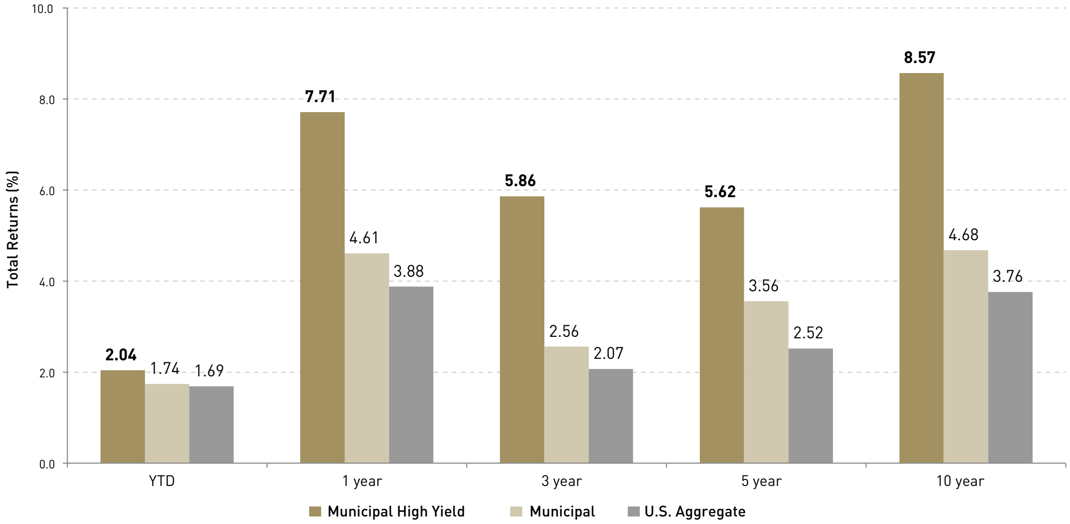

Chart 1 also illustrates that, within municipals as an asset class, the performance differential becomes even more remarkable as you move down the ratings ladder. Note that high-yield municipal bonds (as represented by the Bloomberg Barclays High Yield Municipal Bond Index) historically have

Source: Bloomberg Barclays Index data as of March 12, 2019. High-yield municipals are represented by the Bloomberg Barclays High Yield Municipal Bond Index. Investment-grade municipal data are represented by the Bloomberg Barclays Municipal Bond Index. The Bloomberg Barclays U.S. Aggregate Bond Index represents investment-grade taxable bond data.

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outperformed the investment-grade municipal index (the Bloomberg Barclays Municipal Bond Index) across every trailing time period shown in Chart 1. In addition, the returns of high-yield munis were more than double those of the U.S. Aggregate Index over the three-, five-, and 10-year periods.

And this is before the benefit of the tax-free status of municipals is taken into consideration. Since the majority of the return from municipals derives from tax-free income, the performance advantage that high-yield munis have delivered historically to investors is even more noteworthy.

The Potential for High After-Tax Income

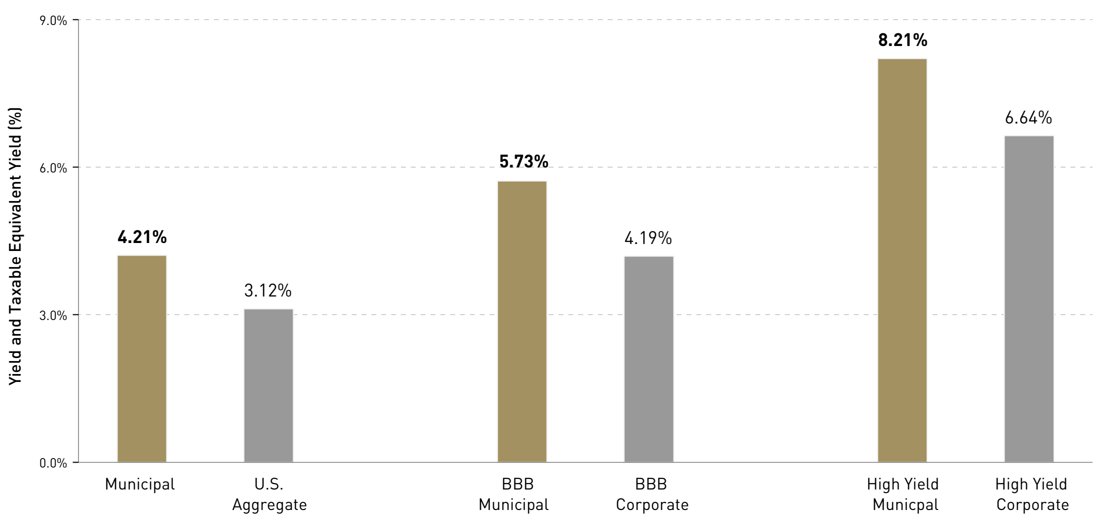
While investors have had a very positive experience in high-yield munis in recent years, why should they consider an allocation to high-yield municipals today? One key reason: tax-free income. Yields across most bond sectors moved higher throughout 2018 as the U.S. Federal Reserve (Fed) gradually raised short-term rates, giving hope to investors seeking income. From December 2015 through December 2018, the Fed raised rates nine times for a total increase of 2.25% on its target fed funds rate.

Despite the headwind of rising interest rates over this period, high-yield municipals performed quite well. For the three years ended December 31, 2018, the High Yield Municipal Bond Index generated average annual returns of 5.77%, comparing favorably to the 2.30% return for the Bloomberg Barclays Municipal Bond Index, and the 2.06% return for the taxable-bond benchmark, the U.S. Aggregate Index.

But yields have come back down in 2019. For example, the 2.62% yield on the 10-year U.S. Treasury bond is over 60 basis points below its peak level in late 2018, as the Fed has made clear that it intends to put its rate hiking cycle on pause. In what remains a low-yield environment, after-tax yields on municipals are relatively attractive, especially in the lower reaches of the credit spectrum. As of March 12, 2019, the tax-free yield on the 'BBB'-rated portion of the investment-grade Municipal Bond Index stood at 3.4%, and the High-Yield Municipal Bond Index offered a yield of 4.9%. But since the income from municipals is generally tax-free, these yields become more attractive on a taxable-equivalent basis. Chart 2 illustrates how those yields translate to an investor in a top tax bracket. High-yield municipals offered a taxable-equivalent yield in excess of 8.2%, well ahead of high-yield corporates.

Chart 2. Investors Today May Benefit from Higher After-Tax Incomes

Tax-equivalent yields * for municipal bond versus taxable indexes, (as of March 12, 2019)



Source: Bloomberg Barclays Index data as of March 12, 2019. Investment-grade municipal data represented by the Bloomberg Barclays Municipal Bond Index and the U.S. Aggregate represented by the Bloomberg Barclays U.S. Aggregate Bond Index. High-yield municipal data represented by the Bloomberg Barclays High Yield Municipal Bond Index and high yield corporate data represented by the Bloomberg Barclays High Yield Corporate Bond Index. *At the 32% tax bracket, the tax-equivalent yield would be 3.66%, 4.99%, and 7.15% for the investment-grade, 'BBB'-rated, and High-Yield Municipal indexes, respectively. Tax-equivalent yield calculation for the municipal indexes above assumes the top marginal tax bracket of 40.8% on investment income, which includes the 37.0% income tax rate and the 3.8% in Medicare tax. This tax rate does not factor in the effect of AMT (alternative minimum tax) or taxes in your individual state. Tax-equivalent yield will vary based on an investor's tax bracket.

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Does this yield advantage come as a result of a higher probability of default? To be sure, investing in high-yield municipals entails an allocation to a below-investment-grade asset class. But, historically, the default experience of municipals has been a fraction of what has been experienced in comparably rated corporate bonds (see Table 1). We believe that high-yield investing requires rigorous credit research and specialized expertise in the nuances of the factors affecting issuer credit fundamentals. For those professional investors with the resources dedicated to conducting this analysis, high yield municipals have offered the potential for attractive opportunity.

Table 1. Historically, High-Yield Munis Have Had Low Default Rates Relative to Comparably Rated Corporate Bonds

Average 10-year cumulative default rates,1970-2016

Credit Quality	10-Year Cumulative Default Rates	
Moody's Ratings	Municipals	Corporates
Baa	**0.40%**	**3.93%**
Investment Grade	0.09%	2.38%
Non-Investment Grade	8.17%	29.70%
All Rated*	0.15%	10.29%

Source: Moody's, "Moody's U.S. Municipal Bond Defaults and Recoveries, 1970-2016," June 2017. Data show the average 10-year cumulative default rates of Moody's rated corporate and municipal bonds for a study covering the period 1970-2016.

*Rating outlooks are not assigned to all rated entities. Data are the most recent available.

While municipal bonds are backed by municipalities, U.S. government securities, such as U.S. Treasury bills, are considered less risky since they are backed by the U.S. government. High-yielding, non-investment-grade bonds (junk bonds) involve a higher risk than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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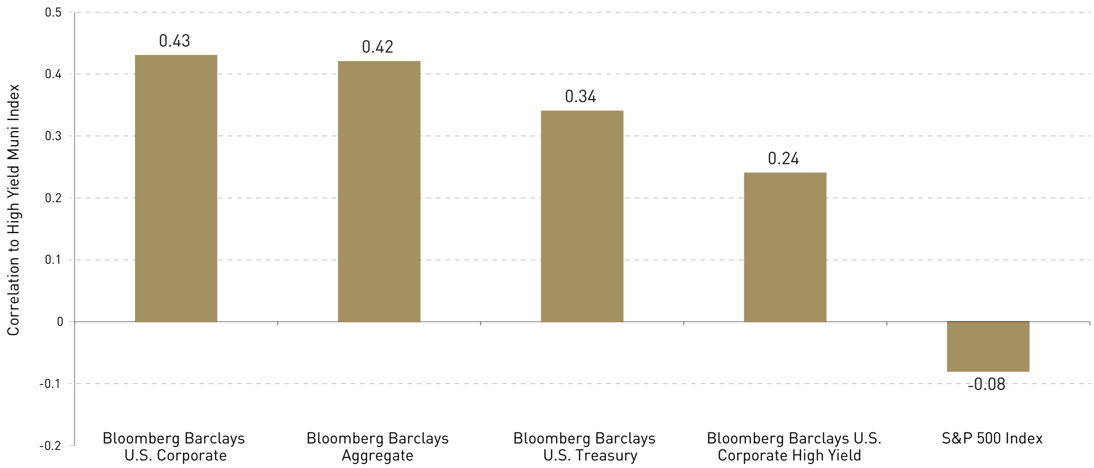
Portfolio Diversification

While high-yield municipals have offered attractive after-tax income and total return on their own, we believe adding the asset class to a broader portfolio has additional benefits. The High Yield Municipal Bond Index has a very different sector profile than the investment-grade Municipal Bond Index, with very little exposure to general obligation (GO) bonds, and a heavier emphasis on revenue bonds relative to the investment-grade Index. Many issues in the high-yield market can be tied to specific projects in several sectors, including health care, education, and industrial revenue bonds backed by a corporate obligor. This can provide diversity of credit exposure relative to a muni portfolio with a heavier weight in state and local GO issues.

As illustrated in Chart 3 (see next page), the asset class has historically had relatively low correlation with major taxable bond indexes, and negative correlation with the S&P 500® Index, so adding high-yield municipals can provide a source of high tax-free income while potentially diversifying investor portfolios.

Chart 3. Historically, High-Yield Munis Have Had a Low Correlation with Taxable Bonds and a Negative Correlation with the S&P 500® Indexs

10-year correlation to high-yield municipal bonds, as of December 31, 2018



Source: Bloomberg Barclays Index data as of December 31, 2018. High-yield municipals are represented by the Bloomberg Barclays High Yield Municipal Bond Index. investment-grade municipal data are represented by the Bloomberg Barclays Municipal Bond Index. The Bloomberg Barclays U.S. Aggregate Bond Index represents investment-grade taxable bond data.

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Summing Up

Given the potential for credit issues (sometimes actual credit risk and sometimes headline risk), the asset class is prone to periodic bouts of volatility. However, the asset class has weathered many such periods, and those investors who have maintained an allocation to high-yield munis have been rewarded historically with high after-tax income and total return. For those investors looking for high income, while keeping their tax bill low and diversifying their portfolios, high-yield municipal bonds are worthy of consideration in today's market.

Risks to Consider: The value of an investment in fixed-income securities will change as interest rates fluctuate and in response to market movements. As interest rates fall, the prices of debt securities tend to rise. As rates rise, prices tend to fall. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The municipal bond market may be impacted by unfavorable legislative or political developments and adverse changes in the financial conditions of state and municipal issuers or the federal government in case it provides financial support to the municipality. Income from the municipal bonds held could be declared taxable because of changes in tax laws. Certain sectors of the municipal bond market have special risks that can affect them more significantly than the market as a whole. Because many municipal instruments are issued to finance similar projects, conditions in these industries can significantly affect an investment. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state and local taxes may apply. High-yield, lower-rated securities involve greater risk than higher-rated securities; portfolios that invest in them may be subject to greater levels of credit and liquidity risk than portfolios that do not. Lower-rated investments may be subject to greater price volatility than higher-rated investments. A portion of the income derived from a municipal bond may be subject to the alternative minimum tax. Any capital gains realized may be subject to taxation. Federal, state, and local taxes may apply. There is a risk that a bond issued as tax-exempt may be reclassified by the IRS as taxable, creating taxable rather than tax-exempt income. Bonds may also be subject to other types of risk, such as call, credit, liquidity, interest-rate, and general market risks. Investments in Puerto Rico and other territories, commonwealths, and possessions may be affected by local, state, and regional factors. These may include, for example, economic or political developments, erosion of the tax base, and the possibility of credit problems.

Diversification does not ensure a profit or protect against a loss in a declining market.

This *Market View* may contain assumptions that are "forward-looking statements," which are based on certain assumptions of future events. Actual events are difficult to predict and may differ from those assumed. There can be no assurance that forward-looking statements will materialize or that actual returns or results will not be materially different from those described here.

Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that markets will perform in a similar manner under similar conditions in the future.

Glossary

A **general obligation (GO) bond** is a municipal bond backed by the credit and taxing power of the issuing jurisdiction rather than the revenue from a given project.

One **basis point** is equal to 1/100th of 1%, or 0.01%, or 0.0001, and is used to denote the percentage change in a financial instrument.

Tax-equivalent yield is the pretax yield that a taxable bond needs to possess for its yield to be equal to that of a tax-free municipal bond. This calculation can be used to fairly compare the yield of a tax-free bond to that of a taxable bond in order to see which bond has a higher applicable yield.

The **Bloomberg Barclays High Yield Municipal Bond Index** is an unmanaged index consisting of noninvestment-grade, unrated or below Ba1 bonds.

The **Bloomberg Barclays U.S. High Yield Corporate Bond Index** is a market value-weighted index which covers the U.S. non-investment grade fixed-rate debt market. The index is composed of U.S. dollar-denominated corporate debt in Industrial, Utility, and Finance sectors with a minimum $150 million par amount outstanding and a maturity greater than 1 year. The index includes reinvestment of income.

The **Bloomberg Barclays Municipal Bond Index** a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. Bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two ratings agencies. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date.

The **Bloomberg Barclays U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. Total return comprises price appreciation/depreciation and income as a percentage of the original investment.

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The credit quality of the securities in a portfolio is assigned by a nationally recognized statistical rating organization (NRSRO), such as Standard & Poor's, Moody's, or Fitch, as an indication of an issuer's creditworthiness. Ratings range from 'AAA' (highest) to 'D' (lowest). Bonds rated 'BBB' or above are considered investment grade. Credit ratings 'BB' and below are lower-rated securities (junk bonds). High-yielding, non-investment-grade bonds (junk bonds) involve higher risks than investment-grade bonds. Adverse conditions may affect the issuer's ability to pay interest and principal on these securities.

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