Diversifying Your Asset Allocation with High-Yield Muni Bonds

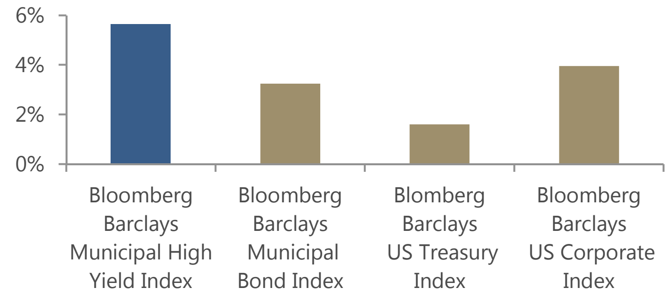
Investors seeking higher yields without excessive risk should take a closer look at high-yield municipal bonds.

by the Standish US Municipal Bond Team

With yields on many familiar fixed-income assets remaining stubbornly low and equity valuations near historic highs, investors may believe they have few options when it comes to earning attractive returns without adding unreasonable risks to their portfolios. Having few options, however, is not the same as having no options. Often overlooked, high-yield municipal bonds may offer these investors a compelling alternative middle ground between the insufficient returns of other bonds and the risks of equities.

The high-yield municipal bond category typically includes bonds issued to fund entities such as toll roads, charter schools, continuing care retirement centers (CCRCs) and real estate and industrial development. As their name suggests, these bonds generally deliver higher yields than others typically found in the broader municipal-bond market, while sharing the same tax-exempt status; this gives them tax-adjusted returns superior to most other categories of fixed income and even approaches the taxable 6.3% return that BNY Mellon Investment Management forecasts US equities will likely deliver from 2017 to 2026. Over the 12-month period ending March 31, 2017, the Bloomberg Barclays Municipal High Yield Index has returned 4.31% vs. the Bloomberg Barclays Municipal Bond Index return of 0.15%.

Average Annual Returns (3/31/12 - 3/31/17)



Source: Standish, Bloomberg Barclays as of May 30, 2017

Besides attractive returns, high-yield muni bonds can also provide valuable portfolio diversification benefits. Historically, they have exhibited relatively low correlation to other fixed-income categories, as well as to equities. As the US Federal Reserve (Fed) continues to normalize monetary policy and interest rates rise, high-yield muni bonds may be less subject to interest-rate risk because they have a higher income component.

	Bloomberg Barclays Municipal High Yield Index	Bloomberg Barclays Municipal Bond Index	Bloomberg Barclays U.S Treasury Index	Bloomberg Barclays U.S. Corporate Index
Bloomberg Barclays Municipal High Yield Index	1.00			
Bloomberg Barclays Municipal Bond Index	0.82	1.00		
Bloomberg Barclays U.S Treasury Index	0.48	0.47	1.00	
Bloomberg Barclays U.S. Corporate Index	0.66	0.74	0.58	1.00

Source: Bloomberg Barclays as of May 24, 2017

No Free Lunch

Like all investment decisions, an allocation to high-yield municipal bonds involves a tradeoff. High-yield muni bonds historically have greater credit risk than the broader muni-bond market. According to Moody's Investor Service, the 10-year cumulative default rate for speculative-grade municipal bonds between 1970 and 2015 is 8.18%. While that is far lower than the 29.42% default rate for corporate high -yield bond issuers, it is significantly higher than the 0.15% default rate for the overall municipal-bond market. High-yield default risks have moderated somewhat in the years since the global financial crisis, as credit fundamentals have improved along with the overall improvement of the US economy. Certain high-yield muni issuers have seen greater improvement in their fundamentals than others; these include toll-road and airline-special facility bonds, whose issuers have benefited from low energy prices. Tobacco securitization bonds have also benefited from the decline in fuel prices as smokers have seen an increase in discretionary income. Tobacco-manufacturer payments to the states, which are the primary source of bondholder repayment, continue in perpetuity until full repayment is achieved.

Management Matters

High-yield municipal bonds are subject to a higher potential for default than typical municipal bonds, making high-quality professional management indispensable when investing in high-yield munis. At Standish, we focus on larger issuers whose diverse bases of purchasers should provide greater liquidity than the majority of high-yield offerings that are small in size with a limited number of investors. Maintaining this liquidity is important to provide flexibility to sell bonds in the event of negative credit developments or if cash is needed to meet redemptions. We also maintain a discipline of focusing on high-yield muni credits with strong fundamental cases for full debt repayment, forgoing the promises of excess yield in cases where some level of "hope" is required that debt payments will be made. Puerto Rico is a prime example of this category where bondholders must rely on government actions and court decisions to determine ultimate recovery.

With skilled active management in place, we believe the return potential and diversification benefits of high-yield muni bonds make them attractive to yield-seeking investors.

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