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UPSIDE | By Jack Hough

Why Munis Are Worth a Look

Municipal bonds faced two key tests this past week—and came out looking sturdy.

The first was a spike in Italian government bond yields that culminated Wednesday with a global flight from risky assets. Muni prices rose, a sign that investors ran toward them, not away from them.

The second was Thursday's bankruptcy filing by Jefferson County, Ala., the largest municipal bust ever. It was expected, but it could have gotten investors thinking that Jefferson was a harbinger rather than an isolated failing. Instead, muni prices held firm.

"Municipals have held on to their place as the second-safest investment in America behind Treasury bonds," says Greg Serbe of Lebenthal Asset Management in New York.

That No. 2 position might be a blessing for yield hunters, because ravenous demand for Treasurys has cut their yields, which move in the opposite direction of price, to a pittance. That has left muni yields looking high by comparison.

On Thursday, 10-year triple-A munis yielded 2.54%, versus 1.97% for the 10-year Treasury. Before the 2008 financial crisis, it was rare for munis to pay more than comparable Treasurys, Mr. Serbe says.

Municipals compare well against corporate bonds, too. Companies must prosper to pay what they owe whereas many munis are backed by the ability to tax. Most munis escape federal taxes and some avoid state taxes, too. They're often a good deal for investors with high tax rates, but the Treasury yield squeeze has left munis with broader appeal.

For an investor who pays 25% in income taxes, the 10-year AAA muni yield is akin to getting 3.4% on a taxable bond—a percentage point more than the highest-quality 10-year corporate bonds pay.

Investors can get even higher yields by picking bonds with lower credit ratings or longer maturities. Someone who expects the economy to get better should buy shorter bonds (around five years) with lower credit ratings (say, double-A-minus instead of triple-A), says Kathy Jones, a fixed-income strategist at Charles Schwab.

As growth resumes, the issuer will benefit from higher tax receipts, and if interest rates move higher, the investor will be able to buy a new bond with a better rate when the old one matures.

An investor who expects the economy to get worse should favor longer bonds (20 years) with high credit ratings, Ms. Jones says. The issuer will be able to weather the downturn, and the rate will prove attractive if policy makers keep core interest rates low for years to come. For the investor who doesn't know whether the economy will get better or worse (roughly all of them), a blend of these two approaches is best, Ms. Jones says.

The key, of course, is picking the right bonds. Some municipalities face budget shortages in the near-term. Others assume unrealistically high returns in pension accounts for their workers, a tactic that lets them set aside less money today but could leave them short years from now, says Robert Novy-Marx, a finance professor at the University of Rochester.

There is another risk to be wary of: a "super-downgrade." Because the big ratings firms—Standard & Poor's, Moody's and Fitch Ratings—review their muni ratings only periodically, there is a chance that they can miss a city's rapid deterioration and then downgrade its bonds by several notches in one swoop, which could cause a steep selloff. It happens only rarely, but owners of individual bonds should be aware of the possibility.

So how to pick munis now? The first step is to consult with financial advisers who specialize in them and understand the risks. Investors should also make use of emma.msrb.org, a website run by the Municipal Securities Rulemaking Board, where they can look up issuer financial information and see what other buyers have recently paid for bonds.

Matt Fabian of Municipal Market Advisors, a Concord, Mass., consultancy, points to the New York City Transitional Finance Authority's 20-year bonds, rated triple-A ("extremely strong") by Standard & Poor's, as a long and safe issue of the sort Ms. Jones cites. The 20-year bonds can be repaid early (or "called") in 10 years. Their "yield to call" is 3.92%.

For a shorter bond with a slightly lower rating, the Allegheny County Hospital Development Authority of Pennsylvania, rated double-A-minus ("very strong"), has five-year bonds that yield 2.14%. Inexperienced bond buyers should stick with double-A-minus and higher ratings, Mr. Fabian says.

Investors looking for broad muni exposure can find it in bond funds. The first choice is whether to use a state-specific portfolio for maximum tax benefits or a national one for the broadest diversification.

"For residents in high-tax states like New York and California, it's hard to beat state funds, but others should stick with national funds," says Jeff Tjornehoj, an analyst at Lipper.

Don't just look for top performers with low fees; consider volatility as well, Mr. Tjornehoj says. Also, funds might be a good bet for investors who want the high yields

Show Me the Muni

Triple-A-rated municipal bonds have occasionally paid more than Treasurys in recent years—a rare occurence.

Source: FactSet Research Systems

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that lower credit ratings bring but need diversification to reduce risk.

For investors who want longer-dated bonds, Mr. Tjornehoj likes the USAA Tax Exempt Long-Term Bond fund, which ranks in the top 14% of funds by performance over the past three years. Its average credit quality is triple-B and its average effective maturity is 17 years. It has a yield of 4.67%, and costs $47 a year per $10,000 invested.

For shorter bonds, the Vanguard High-Yield Tax-Exempt fund has an average effective yield of 11 years. "High yield" is usually synonymous with "junk," but less than 10% of the fund's holdings are junk bonds, or ones rated below triple-B. The average portfolio quality is triple-B, the yield is 4.41%, and Mr. Tjornehoj says the fund ranks in the top quarter of its peers for performance over the past three, 10 and 15 years. It costs $20 per $10,000 invested.

For exchange-traded fund buyers, Mr. Tjornehoj recommends Market Vectors Long Municipal Index, which yields 4.51%, and PowerShares Insured National Municipal Bond Portfolio, which yields 4.59%. Don't let the name of the latter fund mislead. The municipal insurance business is in sharp decline due to the loss of triple-A credit ratings among insurers. Investors now price bonds as if the insurance didn't exist, Mr. Fabian says.

"It means you have to pay closer attention to the finances of issuers," he says, "but it also means there are wide differences in yields and plenty of bargains for investors who know how to find them."

Jack Hough is a columnist at SmartMoney.com.

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