



More Clear Skies for Munis

ETFs investing in state and local government bonds posted stellar returns in 2011. That should continue in 2012.

Many catalysts driving last year's big rally in municipal bonds, including skimpy Treasury yields and improved economic conditions, remain in place. As a result, exchange-traded funds focused on state and local bond issues should prosper again in the first half of 2012.

"Over the past 12 months, muni ETFs have outperformed almost every other bond-fund category except long-term U.S. Treasuries," says Timothy Strauts, a Morningstar analyst.

That isn't the way it looked in 2010 and early 2011. Worries about shaky public finances caused a 7.3% decline in the average long-term muni ETF. But as default rates remained subdued and the economy strengthened, returns took off. Long-term muni ETFs have risen about 18% since late January 2011, and outflows have turned into strong inflows. Benefiting most has been the \$2.6 billion iShares S&P National Municipal Bond ETF (ticker: MUB). Last year, it attracted \$371 million in positive flows, or about 40% of all net flows into muni ETFs.

Muni ETFs' inflows look even more impressive against the \$12 billion yanked from traditional muni mutual funds in 2011, points out Matt Tucker, an iShares fixed-income product manager. He notes that investors worried about credit risks have tended to favor the liquidity ETFs provide.

A big part of the appeal of munis in a low-rate environment is their tax-exempt status. MUB had a distribution yield just shy of 3% late last week, which equated to a yield of roughly 4.6% on a tax-adjusted basis for investors in the highest income bracket. At the same time, benchmark 10-year U.S. Treasuries were yielding just over 2%.

Juicier yields make munis, and particularly longer-term issues, more attractive than government bonds and even some corporates, says Brian Evans, lead manager at Madrona Global Bond ETF (FWDB) -- an ETF that invests in other ETFs. He favors the PowerShares Insured National Municipal Bond (PZA). It has an effective duration of 12.5 years, higher than MUB's 6.7 years, and a pretax yield of 4.4%. "Investors are going to increasingly migrate toward munis since even their pretax yields are beating Treasuries," says Evans.

With the Bush-era tax cuts set to expire at year end, more investors will find themselves in higher tax brackets. That means other taxable bonds will have to produce even higher yields to compensate for

the after-tax income you'd receive from munis," notes Jeffery Timlin, lead portfolio manager of municipal bonds at Sage Advisory in Austin, Texas. The firm has about \$10 billion in assets under management.

The New Year has opened with light muni issuance. That's caused demand to outstrip supply, but RBC Capital Markets' Chris Mauro predicts issuance will increase by about 15% over 2011. During the lull, manager Joe Deane says he has been consolidating smaller positions into larger ones in the Pimco Intermediate Municipal Bond Strategy Fund (MUNI). The actively managed ETF, which doesn't track any benchmark, has generated an estimated \$16 million in net inflows in the opening weeks of 2012. "We are emphasizing quality, value and patience over reaching purely for the best yield spreads," he says.

Such a measured view might sound boring, but it could be effective as the muni rally goes on.

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