ROLF E. LUNDELIUS, PHD, CFA
Quantitative Analyst

The Case for Municipal Bonds

Executive Summary

- For investors who can benefit from tax-exempt income, a fixed-income-only portfolio should contain a substantial allocation to municipal bonds, which offer income that compares very favorably to the taxable income from corporate bonds of similar credit quality.
- The financial crisis of 2008-09 effected important and persisting changes upon the municipal market. Spreads are now wider and express greater sector and idiosyncratic differences between bonds. The nature of municipal bond market risks have also changed post-crisis.
- The current market has recalibrated the risk and return characteristics of municipal bonds, and thus presents both greater risk and greater opportunity to investors.
- Despite these changes, the value of the tax-exemption, the strength of the typical muni issues and a retail-oriented market all point to a continuing opportunity for superior taxable-equivalent returns to the passive investors in the market as a whole.
- Those investors who engage in the particulars of a sector, structure and idiosyncratic pricing and attendant risk will find even greater opportunities that were unavailable in the past.

Introduction

The basic facts about municipal bonds are well known to investors:

- Their income is exempt from federal income tax—and some provide income that is exempt from specific state income taxes.
- They are generally of high quality.
- Their track record suggests defaults are extremely rare and bondholders remain relatively protected.
- State tax exemptions and other factors contribute to market pricing that is susceptible to technical conditions.
- For investors who can benefit from tax-exempt income, municipal income compares very favorably to the taxable income from corporate bonds of similar credit quality.

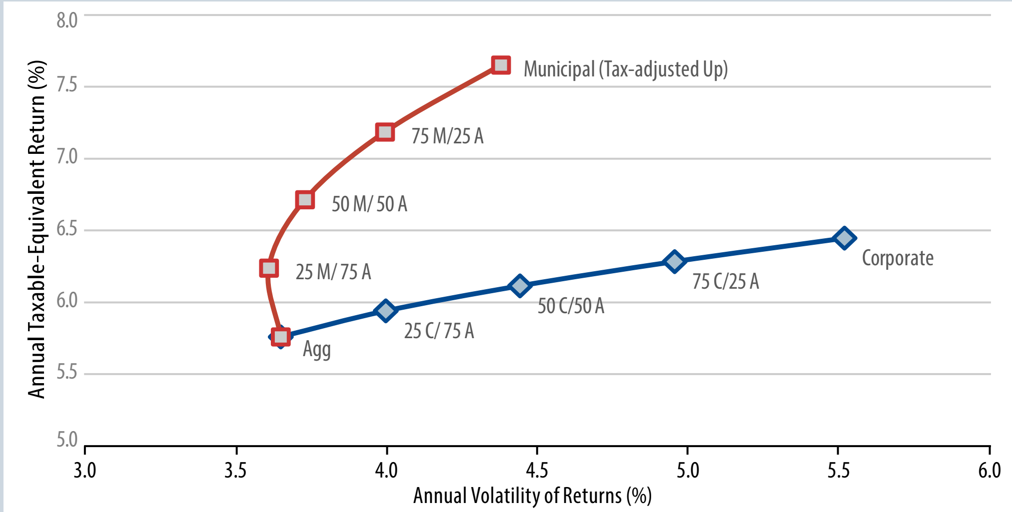
These facts are widely appreciated by investors and factor into implementing a comprehensive investment plan, which requires looking beyond the characteristics of individual asset classes to consider how strategic combinations of these asset classes may perform. For investors who can benefit from tax-exempt income, a fixed-income-only portfolio should contain a substantial allocation to municipal bonds. We favor 25% or more. In the historical study described below, a 25% allocation to municipals increased annualized tax-equivalent return by 0.5% without increasing volatility. In a simulated historical US portfolio that blends fixed-income with equities, a 25% allocation to municipal securities reduced volatility by 3.6% while reducing the annualized tax-equivalent return by only 0.3% as compared with a portfolio solely comprised of stocks. Although an actual investment program is far more complicated in its design, these examples illustrate an important aspect of the historical risk and return characteristics of municipal bonds that merits serious consideration by investors.

Our inclination regarding investment allocations follows largely from the examination of historical data, but it is also important to consider how current market conditions relate to historical circumstances. In fact, the municipal market has undergone important changes that occurred during and after the financial crisis of 2008-2009. Some of these changes have been fundamental, that is, directly affecting the credit quality of municipal issuers and their guarantors. Other changes have been technical, involving federal regulatory, monetary and fiscal conditions.

Historical Risk and Return

The historical taxable-equivalent performance of municipal bonds has often been described as "superior." To illustrate this, we evaluated the risk and return characteristics of simulated portfolios with differing allocations to the Barclays Aggregate Bond Index (the Agg), investment-grade corporate bonds and municipal bonds. Corporate bonds are represented by the Barclays Corporate Bond Index and municipals are represented by the Barclays Municipal Bond Index. Because the Agg already contains corporate bonds, the allocations shown represent overweights to this sector.

Exhibit 1
US Aggregate, Corporate (Nominal) and Municipals (Tax-adjusted Up), January 1994 to March 2015



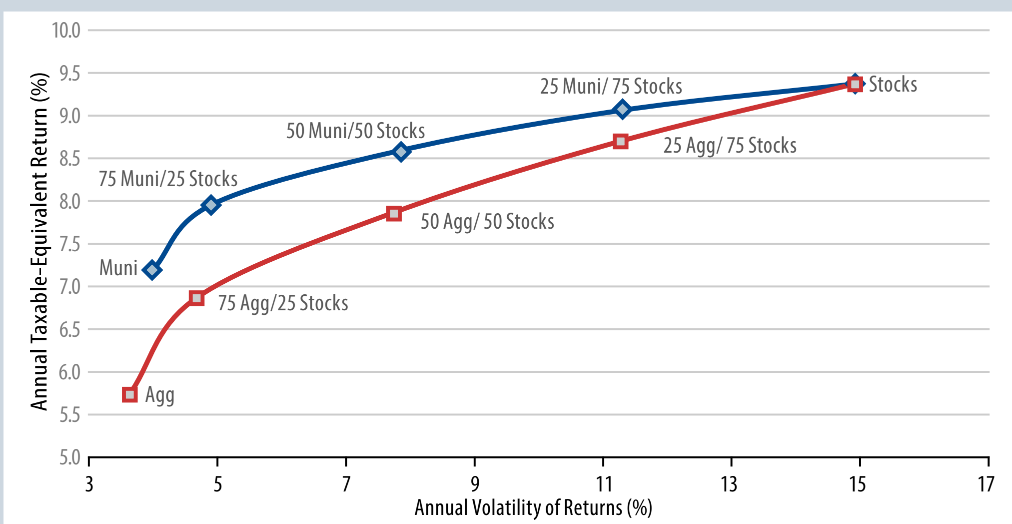
Source: Barclays, Western Asset. As of 31 Mar 15

Exhibit 1 plots the taxable equivalent return (assuming a 35% tax rate) versus the volatility of returns for synthetic portfolios with a range of allocations to municipals and a range of overweights to corporates. The blue line represents the performance of allocations ranging from 100% Agg to 100% corporate. The red line shows the performance of allocations ranging from 100% Agg to 100% municipal.

The dominance of the municipal strategies is obvious. Notice also that the 25% allocation to municipals has an added taxable-equivalent return with about the same volatility as the Agg portfolio. For investors who traded return for volatility, this was truly a "free lunch," and we cite this in support of our preference for a 25% or greater allocation to municipals.

Many investors allocate to a blend of stocks and bonds. The chart below compares the simulated results of diversifying a stock portfolio using the Agg or municipals. In this chart, stocks are represented by the S&P 500 Index.

Exhibit 2
Blended Portfolios: Fixed Income (Municipals/Agg) and Stocks, January 1994 to March 2015



Source: Barclays, Western Asset. As of 31 Mar 15

Looking at Exhibit 2, the higher returns offered by the stock market over the study period are obvious, but not every investor will be comfortable with volatility of 14.9%. Therein lies the value of an allocation to fixed-income: its reduced volatility. Supporting our allocation preference stated in the Introduction, during the study period, the blend of 25% muni bonds and 75% stocks exhibited 3.6% less volatility than stocks alone (11.3% versus 14.9%), while giving up only 0.3% of annualized taxable equivalent return (9.1% versus 9.4%). If the fixed-income component of this allocation had consisted solely of the Agg, the annualized taxable-equivalent return would have been 0.4% lower.

In sum, a substantial allocation to municipal bonds has created value for investors in blended stock and bond portfolios by reducing volatility and delivering taxable-equivalent returns greater than could be achieved with stocks and the Agg.

Crisis, Recovery and the New Market for Municipal Credit

So far, our discussion has focused on the historical experience of large aggregates of securities as represented by published indices, but in practice, investors are faced with numerous choices of individual securities and may choose sector and bond selection strategies that diverge from the large indices. Within the municipal market, the opportunity set for investors has changed dramatically since 2008. Indeed, the financial crisis of 2008-2009 effected important and persisting changes upon the municipal market.

Before the crisis, municipal spreads were typically low and stable, in part because of the monoline insurance companies. However, during the crisis, these insurers were rendered insolvent by their taxable portfolios, and municipal bonds repriced to reflect the general panic in the markets. As the crisis subsided, municipal bond spreads rebounded, but did not return to their previous low levels. In comparison to the pre-crisis market, spreads are now wider and express greater sector and idiosyncratic differences between bonds. In this respect, the post-crisis municipal bond market shows some resemblance to the market for corporate bonds.

The current market has recalibrated the risk and return characteristics of municipal bonds, and thus presents both greater risk and greater opportunity to investors. The disappearance of monoline insurance as a dominant feature of the market has exposed the underlying issuers and structures to analysis and price action. Meanwhile, non-traditional municipal investors have entered the market opportunistically in response to a post-crisis period of extremely cheap valuations and the Build America Bond program.

Even as the diverse risks inherent to municipal bonds have become subject to market pricing, the nature of those risks has changed in the aftermath of the crisis. The long-simmering problems with public pensions have finally become the focus of investor and media attention, and several high-profile bankruptcies and court decisions have raised questions about legal risk in the municipal market. As a result, general obligation debt is no longer perceived to be as secure as it was in the past. Successful investors must trade around these systematic market currents while focusing on the underlying fundamentals.

Western Asset considers mobility of the labor pool to be a key factor in municipal bond decision-making. State and local economies offering healthy economic activity will attract the best companies and their employees. Therefore, investors should pay close attention to signs of potential economic decline in regions. Population loss, stagnant or falling home values, business out-migrations, and reduced tax bases can lead to low financial flexibility. Those are just some of the key factors we watch closely.

Superior Taxable-Equivalent Income for the Passive; Opportunities for the Active

Despite recent changes to the municipal market, its essential features remain unchanged. The value of the tax-exemption, the strength of the typical municipal issuer, and a retail-oriented market all point to a continuing opportunity for superior taxable-equivalent returns to the passive investor in the market as a whole. Those investors who engage the particulars of sector, structure and idiosyncratic pricing and attendant risk will find even greater opportunities that were unavailable in the past.