Taxable municipal bonds: an overlooked asset class

From MacKay Municipal Managers™

Municipal bonds are typically known for offering tax-exempt income, making them a popular choice in taxable investment accounts for retirees, while historically being excluded from the possible mix for qualified retirement plans and IRAs. However, contrary to conventional thinking, taxable municipals are a compelling solution within fixed-income portfolios, both within and outside of retirement plans, as they offer a high-quality issuer base, low historical default rates, attractive yield potential, and total return potential.

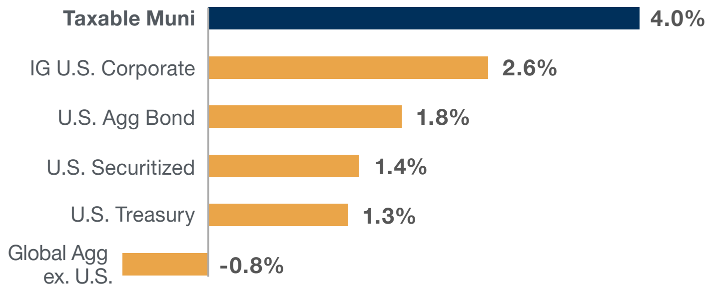
Taxable municipal bonds represent a lesser known, yet growing segment of the $4 trillion municipal market and offer a way for investors, including retirement plan participants who may not require tax-exempt income, to gain exposure to this segment's desirable investment attributes.

Taxable municipals are backed by the same issuers as their tax-exempt counterparts, typically with the same high-grade credit quality, but with higher taxable-yield potential.

By keeping taxable municipals outside the scope of consideration, investors have sacrificed strong historical performance relative to other investment-grade, taxable bond categories. Over the last ten years, the taxable municipal sector's 4.0% annualized total return handily outperformed the 2.6% return for investment-grade U.S. corporate debt and the 1.8% return for the core Bloomberg U.S. Aggregate Bond Index (Figure 1). But, strong historical returns are just one of many reasons that investors may want to consider the asset class. Taxable municipal bonds are garnering interest from non-traditional municipal investors due to their high-quality credit ratings, inefficient pricing, lower correlations, and diversification benefits.

Figure 1: Taxable munis have performed well

10-year annualized total return (%)



Source: Bloomberg; data as of 12/31/2023. Taxable Muni: Bloomberg Taxable Municipal Bond Index; IG U.S. Corporate: Bloomberg U.S. Corporate Investment Grade Index; U.S. Agg Bond: Bloomberg U.S. Aggregate Bond Index; U.S. Securitized: Bloomberg U.S. Securitized MBS ABS CMBS Index; U.S. Treasury: Bloomberg U.S. Treasury Index; Global Agg ex. U.S.: Bloomberg Global Aggregate ex. U.S. Bond Index. Index definitions can be found at the end of this document. Past performance is not indicative of future results.

New interest in an old sector

Institutional interest in U.S. taxable municipal bonds was whetted in 2009 when the Obama Administration created the Build America Bonds (BABs) program to stimulate an economic recovery from the Great Recession. At the time, many states and cities were having difficulty tapping the traditional, tax-exempt municipal bond market to fund capital projects.

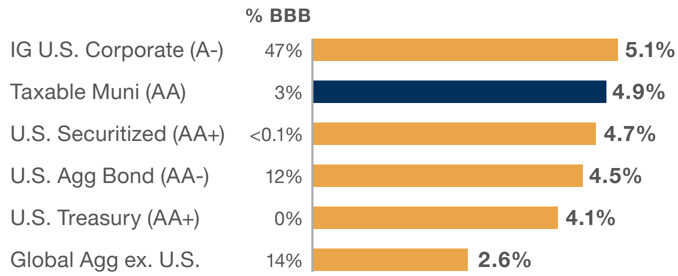
Through BABs, the federal government subsidized the interest cost on taxable municipal bonds to make them affordable to issuers and broaden their potential investor base. Over the two years the program was in effect, issuance of taxable municipal bonds surged from $24 billion in 2008 to $85 billion in 2009 and $152 billion in 2010.[1] Over the past decade the market continued to grow, and today it stands at approximately $830 billion.

Supply piqued demand. Non-traditional municipal investors learned that taxable municipals offered an array of structural benefits, including incremental return potential from inefficient pricing in a fragmented market and attractive yields without the need to sacrifice credit quality (Figure 2). The diversification benefits and possibility of lower capital charges[2] have also resulted in increased foreign demand for taxable municipals.

Today, many institutional investors see taxable municipals as an attractive diversifier for their fixed-income portfolio. Many of these investors welcome the historically higher credit quality and ratings of municipals versus other fixed-income sectors — features that may be attractive for retail investors, including within their retirement plan allocations.

Figure 2. Compelling yield without sacrificing quality

Yield-to-worst



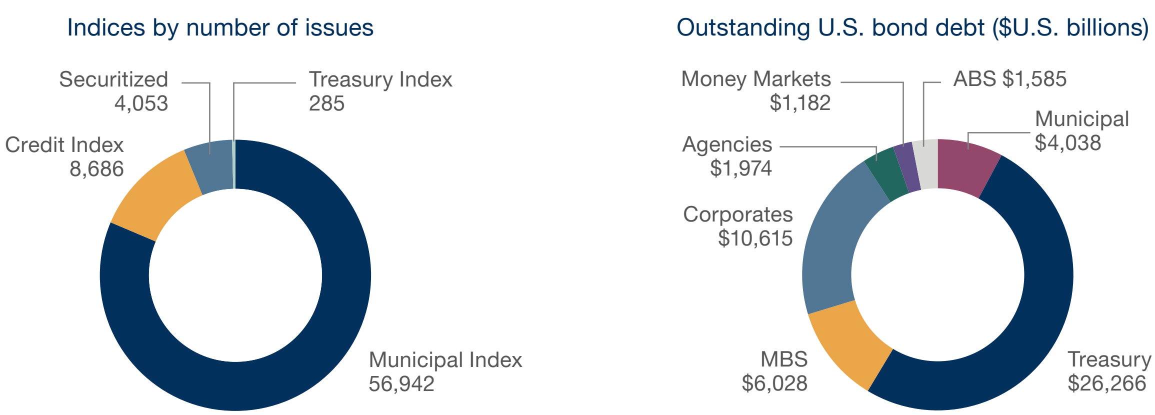
Source: Bloomberg. Data as of 12/31/2023. IG U.S. Corporate: Bloomberg U.S. Corporate Investment Grade Index; Taxable Muni: Bloomberg Taxable Municipal Bond Index; U.S. Securitized: Bloomberg U.S. Securitized MBS ABS CMBS Index; U.S. Agg Bond: Bloomberg U.S. Aggregate Bond Index; U.S. Treasury: Bloomberg U.S. Treasury Index; Global Agg ex. U.S.: Bloomberg Global Aggregate Bond Index. Index definitions can be found at the end of this document. It is not possible to invest directly in an index. Past performance is not indicative of future results.

Pricing inefficiency creates opportunity

The municipal bond market is highly fragmented, and most issues are small; many are too tiny to be included in a market index. Yet the municipal bond index still is comprised of more than 56,000 issuers, representing over 80% of issuers in the broader U.S. bond market. In contrast, the corporate bond market, with more than twice as much value, has far fewer issuers: the corporate bond index includes less than 9,000 issuers. The Treasury market is huge, with over $26 trillion in value, but the index includes just 285 issues (Figure 3).

Municipal market fragmentation, limited sell-side research, and the prevalence of buy-and-hold investors often lead to inefficient pricing. Pricing inefficiencies create opportunity for active investors with an edge in credit research and trading to seek greater yield and total return potential than the sector's typical buy-and-hold investors reap.

Figure 3. The $4.04 trillion municipal market has over 6x the number of issues as the corporate bond market



Source: Bloomberg; data as of 12/31/2023.

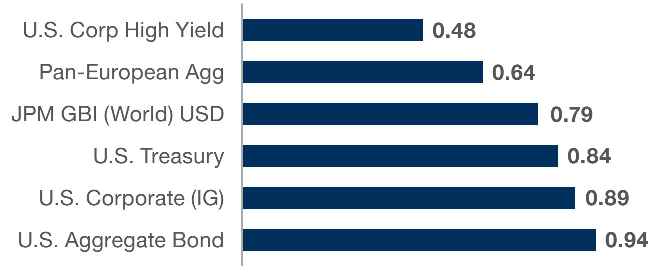
Low correlations and broad diversification

Municipal bonds also provide significant risk management benefits. An allocation to municipal bonds may help manage fixed-income portfolio volatility because municipal bond returns generally have a low correlation to other fixed-income sectors (Figure 4).

Municipal bonds, taxable municipals included, are well diversified in their purpose. They fund toll roads, bridges, light rail lines, airports, university and government buildings, water and sewer systems, fiber-optic telecom lines, and electric supply and distribution systems. The issuers are also diversified by region, credit rating, and security structure (e.g., callable vs. non-callable bonds). As a comparison, the Bloomberg Taxable Municipal Index (ticker: BTMNTR) has 13 distinct investable sub-sectors; in contrast, the Bloomberg U.S. Corporate Bond master (ticker: LUACTRUU) has only three.

Figure 4. Taxable munis diversify other bond sectors

Taxable muni 10-year correlation with other sectors (bps)



Data as of 12/31/2023. U.S. Corporate High Yield: Bloomberg U.S. High Yield Index; Pan-European Aggregate: Bloomberg Pan-European Aggregate Index; JPM GBI (World) USD: JPMorgan GBI Global USD Index; U.S. Treasury: Bloomberg U.S. Treasury Index; U.S. Corporate Investment Grade: Bloomberg U.S. Corporate Investment Grade Index; U.S. Aggregate: Bloomberg U.S. Aggregate Bond Index. Index definitions can be found at the end of this document. It is not possible to invest directly into an index. Past performance is not indicative of future results.

Higher-quality asset class and stable historical ratings

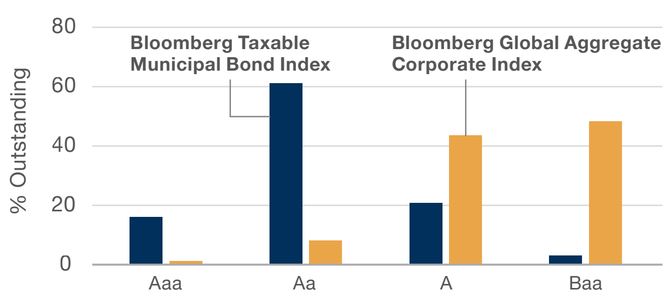
The relatively high-quality nature of municipal bonds is also attractive for risk-conscious investors and institutions seeking to meet their capital requirements efficiently. 77% of U.S. taxable municipal bonds outstanding are double A-rated or better; only a tiny portion is below investment grade. In contrast, only about 9% of the global corporate investment-grade bond market is double-A rated, and nearly 50% is rated BBB (Figure 5).

Historically, municipal bond ratings have been far more stable than corporate bond ratings, as Figure 6 shows. Corporations are vulnerable to event risks, while municipal bond issuers have more latitude to meet shortfalls. State and local governments can raise taxes, if necessary, to support the general obligation bonds that are backed by the issuer's full faith and credit. Revenue bonds, on the other hand, are backed by dedicated cash-flow streams from tolls or other user fees for essential services. In many cases, these public enterprises are virtual monopolies. An airport or water/sewer system, for example, can often raise prices without losing customers. These factors help make municipal bonds a strong late-cycle asset class.

A look at historical default rates also demonstrates the resiliency of the municipal bond asset class. In fact, the average five-year municipal default rate since 2013 is 0.08%, in line with the historical average, which dates back to 1970. Meanwhile, the average five-year global corporate default rate is 7.8% since 2013, up 90 basis points from its historical average of 6.9% since 1970.[3]

Figure 5. Taxable munis diversify other bond sectors

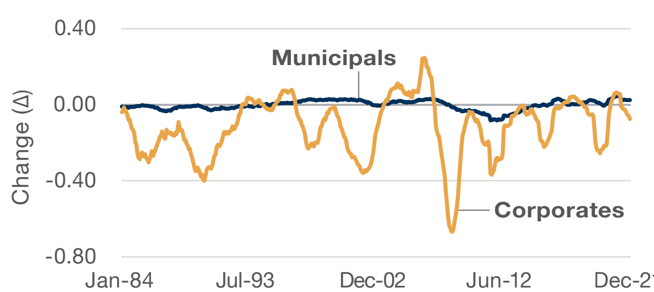
Rating distributions: taxable municipal vs. global corporate bonds (%)



Data as of 12/31/2023. Taxable Municipals represented by Bloomberg Taxable Municipal Bond Index. Global Corporates represented by Bloomberg Global Aggregate Corporates Index.

Figure 6. Muni ratings have been relatively more stable than corporate ratings

Moody's rating drift 1984–2021 for U.S. municipals and global corporates



Source: Moody's US Municipal Bond Defaults and Recoveries, Moody's Trends in Global Corporates Rating Transitions. Moody's US Municipal Bond Defaults and Recoveries, 1970-2022. Data as of January 7, 2023. Rating drift measures the net average number of notches a credit changes over the study period. It is defined as the average upgraded notches per issuer minus the average downgraded notches per issuer.

Core bond funds underutilize taxable munis in portfolios

Relying on core bond funds for broad fixed-income exposure has led many to sacrifice the performance and diversification benefits of taxable municipals. Morningstar data for intermediate core and core-plus bond funds reveal that these portfolios allocate minimal capital to the taxable municipal sector — historically averaging less than 1% of fund assets (Figure 7). The limited investment in municipals by taxable bond fund managers may be attributed to organizational structures and a lack of municipal market expertise.

Investment firms often separate their taxable debt teams from their municipal teams, resulting in taxable bond groups that lack highly specialized municipal market expertise. This lack of expertise may deter taxable investment teams from attempting to navigate the municipal market's distinctive issuer base and market characteristics. Additionally, taxable teams may resist transferring assets to municipal teams or relying on outside specialists. For these reasons, it is important for investors and allocators to seek out taxable muni exposure, rather than count on core taxable bond mandates to effectively utilize the asset class.

"Outside of the box": Consider taxable municipals for investment allocations

In conclusion, as taxable municipals have been a growing, more viable segment of the market, investment advisors and allocators may be well-served to consider taxable municipals as a component of their fixed-income investment mix. Adding taxable municipal bonds may help improve the risk/return profile of a diversified fixed-income asset allocation. Lower correlations, incremental yield potential, and the potential to generate alpha in a highly fragmented asset class all contribute positively to a portfolio's risk/return trade-off. Over the last ten years, an allocation to taxable municipal bonds has improved the return per unit of risk on a portfolio of diversified U.S. bonds.

We believe taxable bond yields remain competitive, and credit quality remains high; there are good fundamental reasons that we believe will allow credit ratings to remain relatively stable and correlations to other fixed-income sectors to remain low.

Figure 7. Core bond funds may be underallocated to municipals

	Allocation (%)				
	Government	Securitized	Corporate	Cash/Derivatives	**Municipal**
Morningstar Intermediate Core Bond Category	29.96%	38.79%	24.55%	3.50%	**1.05%**
Morningstar Intermediate Core-Plus Bond Category	26.48%	43.08%	27.99%	5.15%	**0.57%**

Source: Morningstar Direct as of 12/31/2023

ABOUT RISK:

Investments in bonds are subject to interest-rate risk and can lose principal value when interest rates rise. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner. Municipal securities risks include the ability of the issuer to repay the obligation, the relative lack of information about certain issuers, and the possibility of future tax and legislative changes, which could affect the market for and value of municipal securities. Such uncertainties could cause increased volatility in the municipal securities market.

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INDEX DEFINITIONS

It is not possible to invest directly in an index.

Bloomberg Global Aggregate Bond Index: This index is a broad measure of the global investment-grade fixed-income markets. It includes government, corporate, and securitized fixed-rate bonds from both developed and emerging markets worldwide.

Bloomberg Global Aggregate Corporates Index: This index focuses specifically on investment-grade corporate bonds issued globally. It includes bonds from corporations with high credit ratings.

The **Bloomberg Global Aggregate ex USD Index** is a measure of global investment grade debt from 24 local currency markets. This multi- currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers. Bond issued in USD are excluded.

Bloomberg Pan-European Aggregate Index: This index represents the performance of the investment-grade fixed-income markets in Europe. It includes government, corporate, and securitized bonds from various European countries.

Bloomberg Taxable Municipal Bond Index: This index measures the performance of taxable municipal bonds issued in the U.S. It includes bonds issued by state and local governments or their agencies with maturities greater than one year.

The **Bloomberg U.S. Aggregate Bond Index** represents securities that are SEC-registered, taxable, and dollar denominated. Must have at least one year to final maturity regardless of call features. Must have at least $300 million par amount outstanding. Must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. Must be dollar-denominated and non-convertible.

The **Bloomberg U.S. Corporate Investment Grade Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg U.S. High Yield Index: This index measures the performance of below-investment-grade, or high-yield, corporate bonds issued in the U.S. These bonds typically have a higher risk of default but offer higher yields to compensate for that risk.

The **Bloomberg U.S. Securitized MBS/ABS/CMBs Index** tracks agency mortgage backed pass-through securities (both fixed-rate and hybrid ARM) guaranteed by Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC); investment grade debt asset backed securities; and investment grade commercial mortgage backed securities. The index is constructed by grouping individual pools into aggregates or generics based on program, coupon, and vintage.

Bloomberg U.S. Treasury Index: This index tracks the performance of U.S. Treasury securities across various maturities. It includes Treasury bills, notes, and bonds issued by the U.S. government.

JPMorgan GBI Global USD: This index, provided by J.P. Morgan, tracks the performance of fixed-rate government bonds issued in various developed and emerging markets, denominated in U.S. dollars. It includes bonds with maturities greater than one year.

1. SIFMA.org; U.S. Municipal Issuance

2. Under Solvency II, capital requirements are determined on the basis of a 99.5% value-at-risk measure over one year, meaning that enough capital must be held to cover the market-consistent losses that may occur over the next year with a confidence level of 99.5%, resulting from changes in market values of assets held by insurers.

3. Source: Moody's, U.S. municipal bond defaults and recoveries, 1970-2022, data report, July 19, 2023

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