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Reuters

Time to take profits in high-yield muni funds

By Dean Patterson | 01-07-2007

WASHINGTON, Jan 10 (Reuters) - U.S. investors may want to stop plowing record sums into high-yield tax-exempt bond funds because the oversized returns of recent years are about to end, leaving a lot of downside risk.

Investors who are particularly concerned about capital preservation may also want to take some of their cash out of high-yield munis now to avoid potential price declines in the
future, money managers advised. High-yield munis have greatly enriched investors in recent
years and investors have responded by dumping large amounts of cash into this very small part of the $2.3 trillion tax-exempt bond market.

But all or at least most good trades eventually end, usually when least expected.

High-yield muni funds took in a record $10 billion of new cash in 2006, exceeding the prior record of $8.4 billion in 2005, according to flow tracker AMG Data Services.

In fact, investors have pumped nearly $22 billion into open-ended high-yield muni funds in the last three years and the entire class of funds only totals about $58 billion, according to AMG data.

High-yield munis represent only about 4 percent of the muni bond market, based on the heightening of Lehman Brothers' widely followed indexes.

"All this money chased a small amount of supply. That explains why they did so well and why there is no downside protection now," said Clark Stamper, manager of the Evergreen Strategic Municipal Bond Fund in Corona Del Mar, California.

The focus on high-yield munis has been nothing short of intense lately.

High-yield muni funds represent only about 16 percent of the entire open-ended muni fund universe on a total assets basis, according to AMG data. But high-yield funds accounted for 61 percent of inflows over the last two years, and an even higher proportion over the last four years.

Institutional investors have been as eager to buy high-yield munis as retail fund investors in recent years, money managers said.

"Right now no one cares about risk. It has been a good time to reach for quality for more than a year," said Kenneth Woods, chief executive officer of Atlanta-based Asset Preservation
Advisors Inc. "We have been trying to upgrade our portfolios as much as we can."

Overdone fund inflows is just one of several red flags that have appeared in recent quarters pertaining to high-yield munis, money managers said.

Historically tight credit spreads between high-yield and top-quality munis and low absolute yields are other key signals that investors are not necessarily getting paid enough in extra
yield for the risk they are taking on with high-yield munis, money managers said.

High-yield munis have lower credit quality which generally translates to bigger price declines when economic fundamentals weaken significantly or investors suddenly decide to shed
credit risk en masse, money managers said.

High-yield munis have had a good run due to improving fundamentals, strong demand for yield, and being under-appreciated in the past, investors said.

High-yield munis as an asset class posted a total return of more than 50 percent during the last four years, compared to more than 19 percent for high-grade munis, according to Lehman's indexes. All or most of that yield is exempt from federal taxes.

Bond fund managers usually can not match index performance because their funds carry fees and they usually hold a portion of their assets in cash.

The average high-yield fund posted a total return of 29 percent over the last four years, exempt from federal taxes, according to data from Lipper, a Reuters Company.

The typical high-yield muni fund charges a 116 basis point annual fee, according to Lipper. This gives fund investors even less downside protection in a downturn because fund fees usually do not go down when returns do.

The typical high-yield muni fund yielded 4.39 percent at the end of 2006, down from 4.71 percent at the end of 2005, according to Lipper. Falling yield is another sign of less downside protection.

((Reporting by Dean Patterson))

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