Insight INVESTMENT

US MUNICIPAL BONDS FOR NON-US INVESTORS

SEPTEMBER 2021

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Quick guide to US municipal bonds: US municipal bonds, also known as muni bonds or munis, are bonds issued by US states, cities or local government bodies. They can take the form of general obligation (GO) bonds, funded via tax revenues, or revenue bonds, secured by an income stream from a specific local infrastructure asset. Historically, this has meant that default rates have been low, making munis an attractive investment for risk averse investors, and a way to diversify corporate bond holdings.

The majority of municipal bonds are issued in a format that exempts the holder from US federal income tax, and potentially local state taxes – a significant benefit for many US-domiciled citizens and corporates. However, there is a growing section of the municipal bond market that is issued in a fully taxable format – by issuing fully taxable debt, the issuer has greater flexibility on how they can use the proceeds. Taxable municipal bonds generally trade with a higher gross yield than their tax-exempt counterparts, and this has led to an increase in demand from non-US investors.

EXECUTIVE SUMMARY

NON-US INVESTOR DEMAND IS GROWING // 3

- The search for high quality issuers with historically low default rates is driving non-US demand for municipal bonds
- Global insurance demand and responsible investment trends could further boost demand

TAXABLE MUNIS – A NATURAL LANDING POINT FOR NON-US INVESTORS // 4

- Taxable munis have higher gross yields, making them appear more attractive to non-US investors
- Taxable munis are now a distinct subclass and issuance is growing

BUT NON-US INVESTORS NEED TO THINK BEYOND GROSS YIELD ALONE // 6

- By focusing purely on yield, some investors are limiting their opportunities to take duration, credit and relative-value positions

CHOOSING THE CORRECT STRATEGY // 7

- For total return investors, a flexible approach may be better
- A core portfolio of taxable municipal bonds can be enhanced with strategic positions in tax-exempt bonds to take advantage of changing market conditions

CONCLUSION // 8

US MUNICIPAL BONDS
NON-US INVESTOR DEMAND IS GROWING

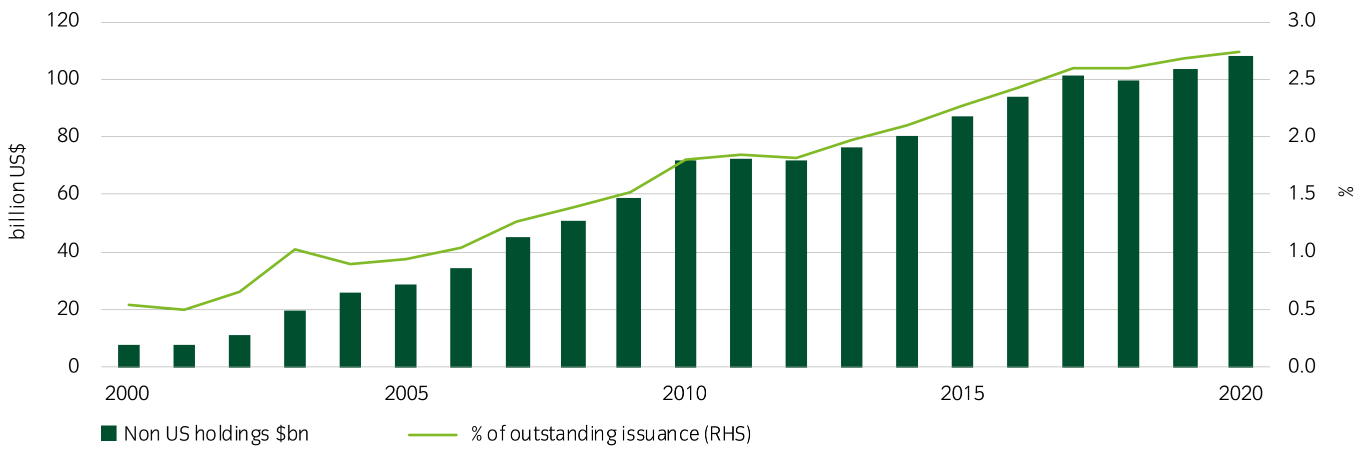
NON-US INVESTORS ARE ONE OF THE FASTEST GROWING SEGMENTS OF DEMAND IN THE MUNICIPAL BOND MARKET. US MUNICIPAL BONDS ARE AN ATTRACTIVE ASSET CLASS FOR NON-US INVESTORS AS THEY ARE GENERALLY HIGH QUALITY (THE BLOOMBERG MUNICIPAL BOND INDEX HAS AN AVERAGE CREDIT RATING OF AA2/AA3), WITH LOW DEFAULT RATES RELATIVE TO THE CORPORATE BOND MARKET. IN THEIR ANNUAL MUNICIPAL DEFAULT STUDY[1] , MOODY'S NOTED THAT THE AVERAGE FIVE-YEAR MUNICIPAL DEFAULT RATE SINCE 2011 WAS 0.12% PER ANNUM, WITH THE AVERAGE OVER THE LAST 51 YEARS 0.08% PER ANNUM.

GROWING INSURER INTEREST AND THE TREND TO RESPONSIBLE INVESTING COULD BOOST DEMAND

Insurers globally are increasingly looking for ways to diversify their corporate credit exposure and have fewer concerns about liquidity than other types of investors as they have limited liquidity requirements, especially in the life insurance sector. The low level of defaults and higher recovery rates relative to corporate issuance is also appealing to insurance investors, and we believe that demand from global insurance companies could be another source of long-term demand growth. For insurers domiciled in the European Union or UK, there is an additional benefit from investing in a bond that qualifies as an 'infrastructure bond', as it can create a regulatory capital benefit, lowering their credit capital charge.

Given the nature of many municipal bonds, the proceeds of which can fund public infrastructure assets, they can also be a natural fit for investors looking to build portfolios that include responsible investment objectives, which may further boost non-US demand in the years ahead. Municipal bond issuance provides funding for both traditional infrastructure, such as roads, bridges and energy and social infrastructure such as education and health care. It is also critical in allowing states and cities to invest in next-generation infrastructure initiatives such as high-speed broadband and the shift towards smart cities.

Figure 1: Non-US muni ownership has been steadily increasing[2]



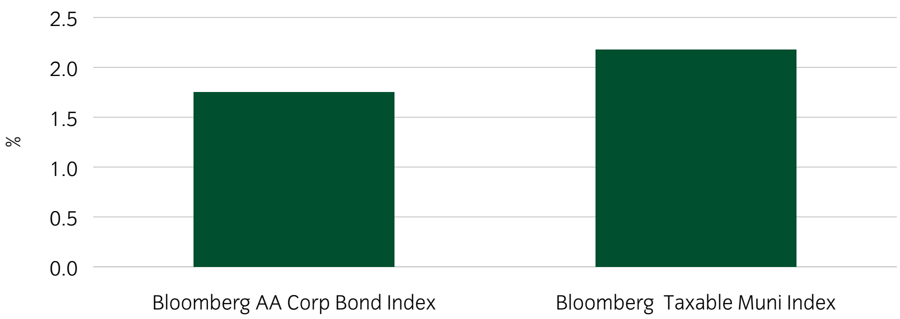
[1] Source: As at 9 July 2021: https://www.moodys.com/research/Moodys-publishes-annual-municipal-default-study-covering-the-51-year--PBC_1294902?cid=7QFRKQSZE021 [2] Source: Insight, US Federal Reserve, SIFMA. Data as at 31 December 2021.

TAXABLE MUNIS – A NATURAL LANDING POINT FOR NON-US INVESTORS

TAXABLE BONDS OFFER A YIELD-ADVANTAGE VERSUS HIGH QUALITY CORPORATE BONDS

As non-US investors are generally ineligible to enjoy the relief provided by tax-exempt bonds, taxable municipal bonds are typically preferred because they offer a higher gross yield than the tax exempt alternative. Taxable municipal bonds also have significantly less call optionality and longer maturities - which is generally better for long-term investors prioritising a predictable and stable income. Taxable munis also offer higher yields than similarly rated US corporate bonds and can have diversification benefits when added to a corporate bond portfolio.

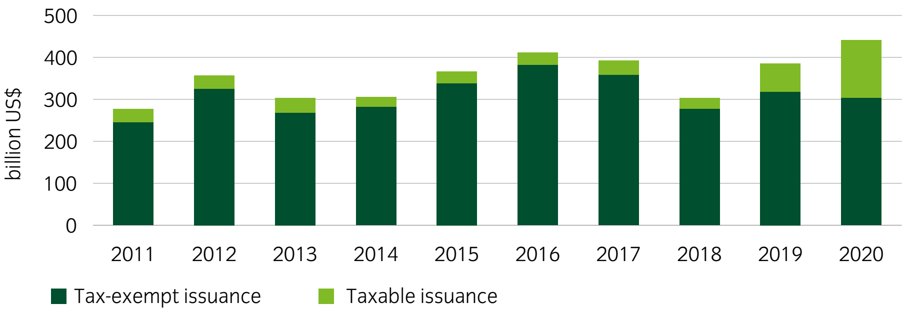
Figure 2: Taxable munis trade at higher yields than similarly rated corporate bonds[3]



THE TAXABLE MUNICIPAL MARKET IS SMALL BUT ISSUANCE IS GROWING – PROVIDING OPPORTUNITIES IN PRIMARY MARKETS

The taxable muni market is significantly smaller in size than the tax-exempt market, however, the proportion of taxable issuance as a percentage of total muni issuance has been growing in recent years. This is primarily a result of the 2017 Tax Cuts and Jobs Act, which prohibited the use of tax-exempt bonds for advanced refunding transactions[4]. As interest rates have declined, many municipal issuers are happy to issue taxable bonds in order to lock in lower funding costs in advance of future maturities.

Figure 3: Taxable bonds have grown as a proportion of total issuance[5]



[3] Source: Bloomberg. Data as at 30 June 2021. [4] Advanced refunding is where an issuer withholds the proceeds of a new bond issue for more than 90 days before using those proceeds to repay the principal of a maturing bond. [5] Source: SIFMA. Data as at 30 June 2021.

TAXABLE MUNIS ARE NOW A DISTINCT SUBCLASS OF THE OVERALL MUNI MARKET

Aside from the underlying tax treatment of taxables versus tax-exempts, fundamental and structural differences exist between the two types of municipal bonds, which makes the taxable market a distinct subclass of the muni market. By comparing some key attributes of the Bloomberg Taxable Municipal Bond Index and Bloomberg Municipal Bond Index these differences become very clear.

Figure 4: Key attributes: tax exempt versus taxable municipal debt[6]

US Municipals	Taxable	Tax exempt
Founding year of asset class	1986	1812
Tax implications for non-US investors	Coupon interest paid gross	Coupon interest paid gross
Correlation to US Treasuries	61%	32%
Correlation to US IG credit	64%	58%
Debt outstanding	$460.6 billion	$3.0 trillion
2020 annual issuance	$137.9 billion	$304.2 billion
Average daily volume	$1.2 billion	$6.1 billion
Index characteristics: Bloomberg Indices	**Taxable Municipal Bond Index**	**Municipal Bond Index**
Market value of outstanding issues	$462 million	$1,688 million
Number of outstanding issues	8,636	56,248
Average yield to worst	2.2%	1.0%
Average rating	AA3/A1	AA2/AA3
Duration to worst	8.9 years	4.8 years
Average maturity	16 years	13 years
Percentage of issuance that is callable	30%	72%

[6] Source: Insight and Bloomberg. Data as at 30 June 2021. Bloomberg Tax-exempt Municipal Bond Index versus Bloomberg Municipal Bond Index.

NON-US INVESTORS NEED TO THINK BEYOND GROSS YIELD ALONE

RISK-ADJUSTED RETURN

When assessing the historical gross total return of the taxable municipal index and the municipal (tax-exempt) index, we find that the high-level summary of risk-for-reward is actually similar. On an annualised basis, taxable municipal bonds have delivered a roughly 150% higher return than tax-exempt municipal bonds, with 150% additional volatility and max drawdown (see Figure 4). Longer-term data suggests that an exclusive preference for taxable or tax-exempt municipals is a linear choice of how much risk for-reward an investor is seeking. By considering even a simple static investment in a 50/50 blend of taxable and tax-exempt indices, it is possible to improve an investor's risk-adjusted return.

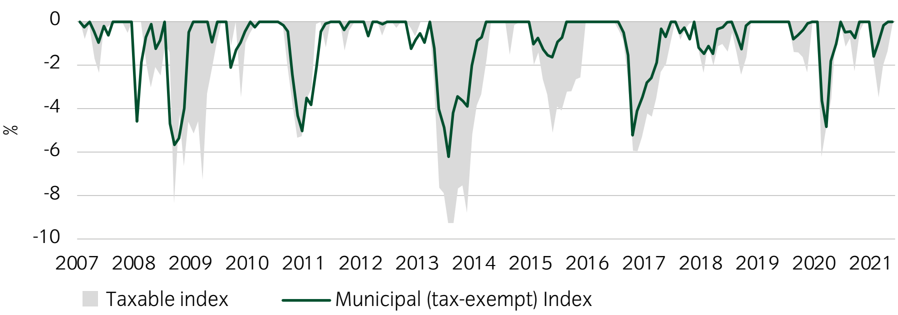
Figure 5: Risk-adjusted return for taxable, tax-exempt and blended municipal bonds[7]

	Taxable	Tax-exempt	50/50
Annualised return	6.4%	4.4%	5.4%
Annualised return (volatility)	6.4%	4.3%	4.8%
Return/risk	0.99	1.03	1.12
Max drawdown	-9.3%	-6.2%	-7.7%

DURATION CAN IMPACT DRAWDOWNS

Tax-exempt municipal bonds tend to have a significantly lower duration profile. This makes the tax-exempt market behave more defensively during periods of rising yields. We can observe that the taxable municipal index typically suffers steeper drawdowns and takes longer to recover than its tax-exempt counterpart (see Figure 6).

Figure 6: Taxable and tax-exempt municipal bond Index drawdowns[8]



[7, 8] Source: Bloomberg. Data as at 30 June 2021. Bloomberg Tax-exempt Municipal Bond Index versus Bloomberg Municipal Bond Index.

INCOME OR TOTAL RETURN? CHOOSING THE CORRECT STRATEGY IS KEY

Rather than focus purely on yield, we believe that non-US investors should invest in municipal bonds with a strategy best aligned with their investment objective.

FOR TOTAL RETURN INVESTORS WE BELIEVE A FLEXIBLE APPROACH IS BETTER

Taxable municipal bonds, all else equal, tend to provide a higher gross yield. However, the tax-exempt municipal bond market is significantly larger, with deeper liquidity and far greater opportunity for diversification. Having the flexibility to invest in both taxable and tax-exempt issues provides the opportunity to shift an allocation to the most suitable market for an investment outlook.

In ordinary market environments, we believe a non-US investor should maintain the majority of their portfolio invested in taxable municipals in an effort to benefit from the higher gross yields available. A strategic allocation to the tax-exempt market can then be made depending on changes in the interest-rate, tax and liquidity environments. This flexibility also introduces the ability to exploit relative value opportunities that can occur between the taxable and tax-exempt municipal markets when market dislocation impacts the pricing benefit of tax-exempt municipal bonds.

An additional total return consideration lies in the ability to purchase lower-rated credit issues. There is greater issuance of BBB and high yield bonds in the tax-exempt municipal market, and by focusing exclusively on taxable issues, opportunities to enhance yield via lower rated credit can be lost.

FOR INCOME-ORIENTED INVESTORS TAXABLE BONDS ARE GENERALLY BETTER

For buy-and-maintain investors seeking to immunise exposures with a relatively safe instrument or seeking to enhance income over a specific timeframe, a portfolio overweight to taxable municipal bonds is generally preferred.

Contrary to investors focused on a total-return investment objective, income-oriented investors are more concerned with safely maximising yield versus discretely specific liability profiles and/or time maturities. More specifically pertaining to buy-and-maintain strategies (such as asset liability matching and fixed term maturity strategies) intra period market liquidity, volatility, and even total returns are of secondary concern. As such, an investment portfolio that more closely matches the investor's specific circumstances likely justifies a heavier weight toward taxable municipals.

CONCLUSION

Municipal bonds can provide a number of positive solutions for non-US investors. However, it is important that these investors consider many factors when deciding how to invest in taxable vs. non-taxable municipal bonds. These considerations include size, duration, demand, total return and income generation. Additionally, an investor's objectives need to be considered. Total return investors may have differing needs than income-oriented investors, while investors with responsible investment objectives or those with long-term objectives may be more focused on specific issues and characteristics of subsets of the market. In short, we believe that the form of a municipal bond investment should follow the needs of the investor.

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IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees and charges and these can have a material detrimental effect on the performance of an investment.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed Income

Where the portfolio holds over 35% of its net asset value in securities of one governmental issuer, the value of the portfolio may be profoundly affected if one or more of these issuers fails to meet its obligations or suffers a ratings downgrade.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Where leverage is used as part of the management of the portfolio through the use of swaps and other derivative instruments, this can increase the overall volatility. While leverage presents opportunities for increasing total returns, it has the effect of potentially increasing losses as well. Any event that adversely affects the value of an investment would be magnified to the extent that leverage is employed by the portfolio. Any losses would therefore be greater than if leverage were not employed.

FIND OUT MORE

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