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An Active Approach to Investing in Taxable Municipal Bonds

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In brief:

- **Strategic case** – The case for investing in the taxable municipal bond asset class is based on its high quality, diversification and yield benefits and its defensive characteristics.
- **Index construction and benefits of an active approach** – Indices are highly concentrated and lack breadth, as over 73,000 taxable municipal issues do not meet inclusion criteria.[1] A flexible, active approach applying traditional alpha levers and liquidity considerations, we believe, maximizes the potential benefits of the asset class.
- **Attractive entry point** – Yields at decade highs and the defensive nature of the asset class make it an appealing time to consider an allocation as the US Federal Reserve engineers a slowdown in economic activity in the US.

Taxable municipal bonds are increasingly of interest to institutional investors such as pension funds and insurance companies with extended time horizons and a desire for high-quality income. The appeal of the asset class has grown globally: non-US investors have become larger participants in the municipal market with their total exposure growing from $8 billion in 2000 to $112 billion in the first quarter of 2023.[2] A surge in supply, resulting from a change in advanced refinancing requirements favoring taxable issuance, has helped meet global demand. Over the past five years the taxable municipal universe has grown by about one-third, to $669 billion, despite advanced refunding supply tailing off as borrowing costs have risen.[3] Even with such growth, the size remains small relative to other global fixed income markets; a feature that along with lower levels of supply, has left retail participants largely on the sidelines. The asset class continues to be dominated by institutional investors.

The taxable municipal asset class comprises a large universe of bonds — over 81,000 issues — with unique characteristics, driven in part by index construction methodologies.[4] Only 0.4% of those issues qualify for inclusion in the US Aggregate indices, and just 12% are included in the Bloomberg Taxable Municipal Bond Index.[5] The degree of investor participation in these indices influences inefficiency and opportunity across the universe. Participation in the US Aggregate indices is broad, enhancing liquidity and deepening the pool of investors familiar with the securities. Outside the US Aggregate, the pool of investor participants is not as deep, and inefficiencies, both mispricing of credit and perceived liquidity, increase.

In addition to a lack of broad universe representation, indices can be highly concentrated. As an example, prior to its upgrade to an A index rating earlier this year, the state of Illinois general obligation bonds comprised almost 54% of the BBB portion of the Bloomberg Taxable Municipal Index.[6] Clearly, this level of concentration is not an optimal neutral position and limits the potential contribution from a large and diverse pool of index-eligible and off-index BBB-rated issues. Concentrated positions in the index and a significant universe of off-index issues are reasons we believe a flexible, active approach makes sense for this asset class.

In this paper, we discuss the strategic case for investing in the asset class and present the argument for active investment to seek alpha. Finally, we review why we think it is currently an attractive time to consider an allocation to the taxable municipal market.

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Strategic case

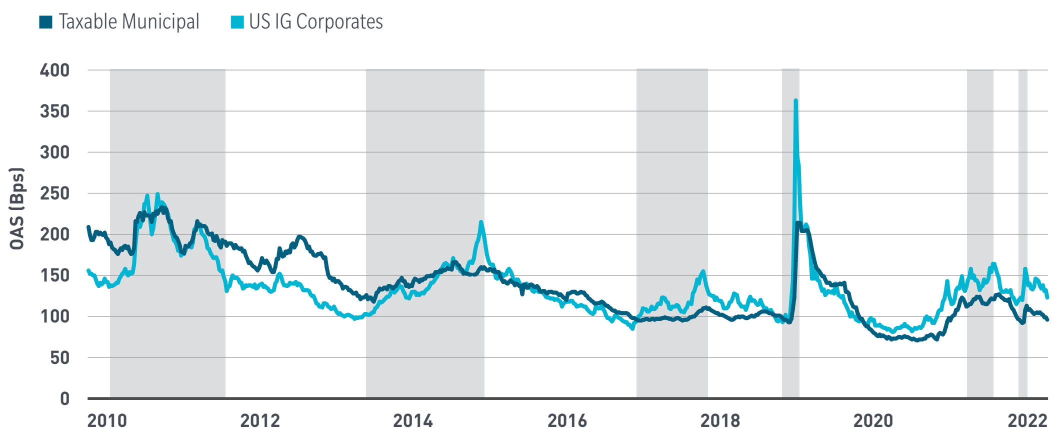
There is a robust case to be made for institutional investors to have strategic exposure to taxable municipal bonds. They fall between US Treasuries and investment grade (IG) corporate bonds on both the risk/return continuum, diversification to equities spectrum, and compare favorably to corporate bonds on several other dimensions.

Higher quality – The makeup of the investable taxable municipal universe is higher quality than that of the investment grade corporate bond universe; using the indices as proxies, about 75% of taxable municipal bonds are AAA- or AA-rated, while only 8% of investment grade (IG) corporate bonds are AAA- or AA-rated.[7]

Default rates – Municipal bonds have historically had much lower default rates than IG corporate bonds overall and at each rating level. Moody's 10-year average cumulative default rate is 2.1% for IG-rated corporate bonds and 0.1% for municipal bonds.[8] The low default rates are a testament to the historical stability of revenue sources servicing municipal debt through economic cycles.

Defensive sectors – Revenue-backed municipal bonds largely comprise essential service sectors — utilities, transportation, education and health care, for example — and have defensive characteristics as a result. These sectors typically exhibit far less credit sensitivity than corporate sectors in the event of a recession or slow down (see Exhibit 1).

Exhibit 1: Taxable Municipal and US Corporate Spreads



Source: Bloomberg. Daily data from 31 December 2010 through 30 June 2023. Shaded regions represent period of spread widening. Areas of spread widening defined as time periods in which US IG Corporate spreads widened at least 48 bps (48 bps being the latest episode of US IG Corporate spread widening in the spring of 2023). OAS = Option adjusted spread. Taxable Municipal = Bloomberg Taxable Municipal Bond Index. US IG Corporates = Bloomberg US Agg Corporates Index. It is not possible to invest directly in an index.

Lower correlation to equities – The Taxable Municipal Index has historically had a lower correlation than the US Aggregate Corporate Index to the S&P 500 Index — 0.35 versus 0.62[9]— demonstrating strategic diversification benefits.

These attributes result in a unique, defensive return stream, offering valuable diversification during periods of equity market weakness (see Exhibit 2).

Exhibit 2: Diversification Potential During Periods of Equity Weakness

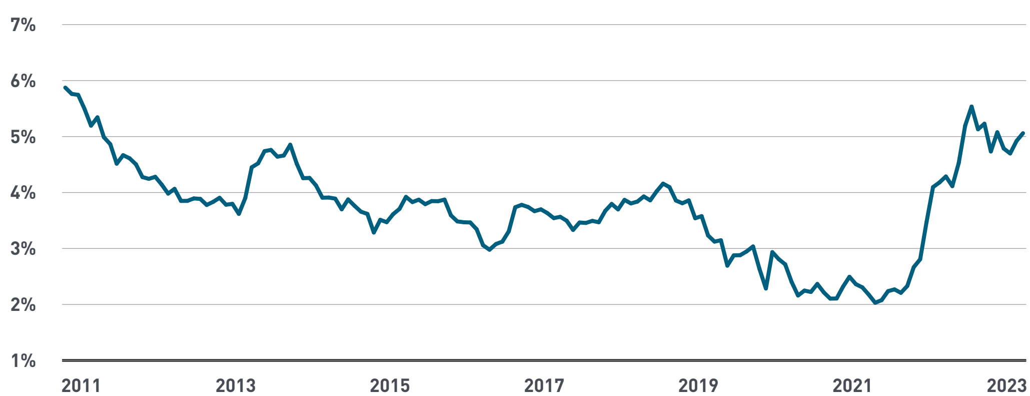
Drawdown Period	MSCI World	Taxable Municipal	US Treasury	US Corporate
4/2/2012 - 6/4/2012	-9.4%	4.0%	3.4%	2.0%
9/14/2012 - 11/16/2012	-6.7%	3.9%	1.5%	2.7%
5/22/2013 - 6/24/2013	-7.2%	-6.5%	-2.0%	-4.3%
9/19/2014 - 10/15/2014	-8.2%	3.5%	2.5%	2.5%
5/21/2015 - 8/25/2015	-12.2%	1.4%	0.9%	-1.2%
11/4/2015 - 2/11/2016	-13.9%	6.1%	3.5%	0.1%
9/28/2018 - 12/24/2018	-17.2%	2.0%	2.3%	-0.3%
5/3/2019 - 6/3/2019	-5.8%	3.9%	2.9%	1.9%
2/12/2020 – 3/23/2020	-34.0%	-1.2%	5.8%	-11.9%
6/8/2020 - 6/11/2020	-5.8%	2.5%	1.4%	0.2%
9/2/2020 - 10/30/2020	-7.9%	-2.0%	-1.2%	-1.3%
9/2/2021 - 10/4/2021	-5.2%	-0.5%	-0.5%	-0.3%
1/3/2022 - 10/12/2022	-26.0%	-18.9%	-12.7%	-18.3%

Past performance is not indicative of future results. It is not possible to invest directly in an index.
Source: Bloomberg. MSCI World = MSCI World Index (net dividends).Taxable Municipal = Bloomberg Taxable Municipal Bond Index. US Treasury = Bloomberg US Treasury Index. US Corporate = Bloomberg US Corporate Investment Grade Index. Data reflect the total holding period return for each time frame listed. Returns are in USD and unhedged.

Duration needs – In addition to the quality and defensiveness generally offered by municipal bonds, issuance across the full maturity spectrum enables investors to target specific duration needs. The full-spectrum maturity representation differs from that of corporate bonds, which lack issuance between 10 and 30 years. When combined with the lack of AAA- and AA-rated credits, corporates may be unable to offer high-quality exposure with incremental spread to Treasuries for institutional investors seeking a duration in the 15- to 25-year range. While a smaller asset class, taxable municipal bonds may offer investors exposure in the segments where corporate bonds are lacking.

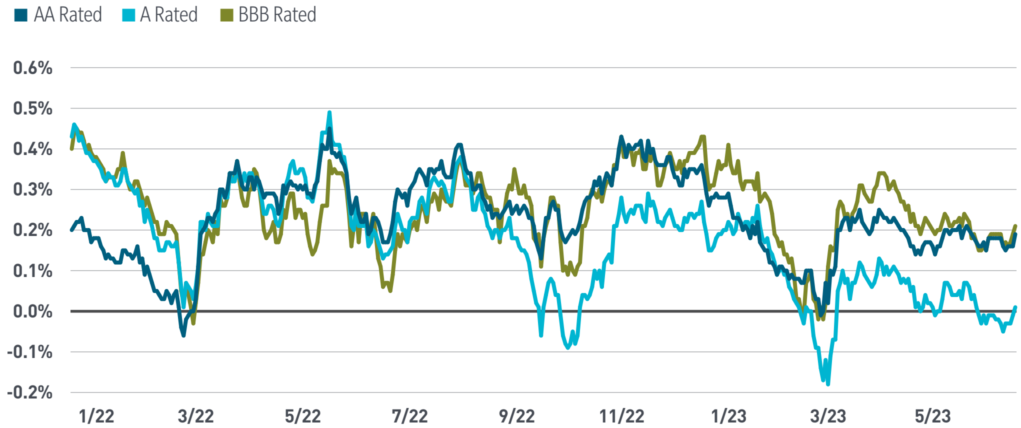
Yield benefit – If we examine municipal bond yields on a historical basis (Exhibit 3) and relative to corporate bonds (Exhibit 4), we see the US Treasury rate adjustment in 2022 pushed taxable municipal yields to their highest level in 10 years with the second quarter of 2023 ending at 5.1%.

Exhibit 3: Taxable Municipal Index Yield-to-Worst %



Source: Bloomberg. Daily data from 31 January 2011 through 30 June 2023. Taxable Municipal = Bloomberg Taxable Municipal Bond Index.

Exhibit 4: Taxable Muni Minus Corporate Yield-to-Worst (bps)



Source: Bloomberg. Daily data from 31 January 2022 through 30 June 2023. Taxable Municipal = Bloomberg Taxable Municipal Index. US Investment Grade = Bloomberg US Corporate Index.

At each quality tier, compensation is higher for taxable municipal bonds than it is for corporate bonds. For example, AA-rated taxable municipal bonds offer a yield premium of 19 basis points over AA-rated corporate bonds.[10] What drives this yield advantage? Years ago, the yield advantage could mainly be attributed to a longer duration compared to the corporate index. A decade ago, the duration of the taxable muni index was almost three years longer than that of the corporate index. Today, that difference is just 8/10ths of a year. Given this compression, we attribute the yield advantage of taxable munis to its broad, fragmented nature, index construction methodology and liquidity more so than duration. Let's take a closer look.

Index construction and an active approach

Indices serve as systematic, transparent representations of segments of a market that they are designed to target. In the case of taxable municipal bonds, the indices may be used to represent the asset class, but they do a poor job of both reflecting the breadth of the universe and constructing an efficient exposure.

With over 81,000 issues in the universe, the taxable municipal asset class is unique in its breadth compared to other fixed income sectors. Indices overlay inclusion rules that segment the universe based on issue size. Bonds included in the US Aggregate Index must be at least $300 million at the security level, those included in the Taxable Municipal Index must be an issue size of at least $75 million and at least $7mm at the security level (this index includes the securities in the US Aggregate Index as well). Issue sizes unable to meet this criteria are not index eligible (see Exhibit 6). A by-product of these index groupings is they attract different buyer bases.

The pool of market participants and assets invested in strategies benchmarked to the Aggregate index is far larger and more diverse than those benchmarked to the taxable municipal index. The result is a differential in liquidity across these indexes and off-index issues, illustrated in Exhibit 5. The figures in Exhibit 5 are Bloomberg's Liquidity Score, which is a relative percentile rank of expected liquidity of a peer group. Liquidity is measured as the cost to transact a certain range of volumes within one day. A rank of 1 is deemed the "least liquid" and 100 is deemed the "most liquid."

Taxable municipal bonds may offer institutional investors the opportunity to trade credit risk for illiquidity risk, upgrading quality and defensive attributes while maintaining or enhancing yield levels.

Exhibit 5: Bloomberg Liquidity Cost Assessment

	Taxable Munis in US Aggregate Index	Bloomberg Taxable Municipal Index	Out-of-index Taxable Munis and those with Corporate CUSIPs not in the US Agg
AAA	62	58	56
AA	61	55	59
A	63	55	47
BAA	44	42	32
Total	**61**	**56**	**55**

Source: Bloomberg as of 18 April 2023

In addition to impacting levels of liquidity across the asset class, index inclusion rules have the opposite effect of excluding the vast majority of the universe. Over 73,000 issues are excluded from the taxable municipal index, or 88% of the universe. Only 313 issues qualify for inclusion in the US Aggregate index at present. Index inclusion rules severely limit the availability of issues in higher-spreading ratings tiers. The number of taxable municipal issues rated A/BBB in the US Agg is 76, and in the taxable municipal index 1,891, compared to 3,971 outside the indices.[11] This lack of representation results in heavy index concentrations in the BBB tier, for example. As mentioned, prior to its upgrade to an A index-rating, the state of Illinois general obligation bonds comprised 54% of the BBB portion of the taxable municipal index.[12] To summarize, indices lack a broad representation of the taxable municipal universe and a flexible, active approach unlocks potential return and yield maximization while still realizing the defensive, low default rate and correlation benefits of the asset class.

As stated in the introduction, retail investors have little presence in the taxable muni market, reflecting the smaller market size and a lack of familiarity, especially compared to the tax-exempt market. Morningstar, for example, has yet to see the need to create a taxable municipal fund universe for the US retail market. The lower levels of liquidity, and associated higher trading costs, also limit application in retail markets. However, these characteristics can have immense appeal to institutional investors who have long-term holding periods or buy and hold approaches, and are willing to accept a degree of illiquidity for potentially higher levels of yield compensation. Taxable municipal bonds may offer institutional investors the opportunity to trade credit risk for illiquidity risk, upgrading quality and defensive attributes while maintaining or enhancing yield levels.

Exhibit 6: Taxable Municipal Bonds: Number of Securities

	Taxable Munis in US Aggregate Index	Bloomberg Taxable Municipal Index	Out-of-index Taxable Munis and those with Corporate CUSIPs not in the US Agg
AAA	45	2,024	4,495
AA	192	5,619	18,175
A	68	1,693	3,660
BBB	8	198	311
Below IG	0	0	107
Not Rated	0	0	46,547
Total	**313**	**9,534**	**73,295**

Source: Bloomberg, MFS Research as of 30 June 2023

In addition to the strategic benefits offered by the taxable municipal asset class outlined in the prior section, there is a persuasive case to be made for a flexible, active approach to maximize the opportunity.

MFS® team and approach

Given the breadth and diversity of borrowers in the asset class, we believe an experienced team with similarly diverse expertise is a prerequisite for success. The MFS team includes fundamental analysts, lawyers and traders, all collaborating and contributing their own perspective. Fundamental analysts offer opinions on primary and secondary market opportunities for index and off-index bonds, with a particular focus on A- and BBB-rated issues where greater inefficiencies exist. Lawyers embedded in the investment team weigh in on complex agreements and advise on which security features to avoid. The quality of traders' relationships with the street in an inefficient market is key, as is their ability to consult with corporate bond traders in finding relative value in the market. Trading in the municipal bond market is based primarily on person-to-person discussions with national and local firms rather than the electronic trading that is common in the more efficient markets, elevating the importance of traders and their relationships in the municipal market.

MFS has invested in municipal bonds since the 1970s and in the taxable segment of the market since 2009. Our approach is characterized as active, long term–focused and downside risk aware. We believe MFS portfolios deliver much more efficient exposures to the taxable municipal universe than is represented through indices. For example, the MFS flagship strategy has over 90% active share and has added more than half of excess return from off-index positions historically. A full toolkit of alpha levers, including quality, sector, security, duration and curve, has contributed to relative performance.

Index construction methodologies limit the usefulness of indices as guides for portfolio construction and a flexible, active approach helps maximize the diverse opportunity available in the asset class.

Liquidity is considered in every decision as we seek to ensure a yield premium for smaller bonds that are less actively traded. Where appropriate, liquidity buckets are maintained in portfolios to ensure the ability to adjust the portfolio to reflect changing views. Importantly, while we recognize that achieving excess return or yield targets are primary goals, we manage with a keen eye to mitigating downside exposure given clients' desire for taxable municipal bonds to provide high quality diversification.

Attractive entry point

This is an opportune time to enter the taxable municipal bond market based on current yields and the defensive attributes of the asset class, particularly with many indicators pointing to a potential economic slowdown in the United States. Yields are at their highest level in 10 years, presenting an attractive entry point for yield-sensitive, long-term holders seeking high-quality fixed income exposure.

The essential services that make up many of the revenue sectors in the municipal market typically have demonstrated defensive characteristics in recessionary environments. While current fundamentals of municipal bonds are peaking at very strong levels, we believe any slowing in the economy should have minimal broad impact on municipal credit ratings.

Conclusion

The taxable municipal bond asset class has furthered its foothold around the world as a surge in supply over the past five years and a very attractive combination of quality and yield have captured increasing interest from global institutional investors. In our view, index construction methodologies limit the usefulness of indices as guides for portfolio construction and a flexible, active approach helps maximize the diverse opportunity available in the asset class. Now may be a time to consider an allocation, as historically high yields augur attractive subsequent returns and a defensive sector orientation may offer resilience in an economic downturn.

Endnotes

[1] Source: Bloomberg, MFS Research, 30 June 2023. Includes taxable municipal bonds and municipal bonds issued with corporate cusips not in any index.

[2] Source: Board of Governors of the Federal Reserve System, Financial Accounts of the US Z.1 Table as of 8 June 2023.

[3] Source: Bloomberg as of 3 July 2023.

[4] Source: Bloomberg, MFS Research, 30 June 2023

[5] Source: Bloomberg, MFS Research, 30 June 2023.

[6] Source: Bloomberg as of Feb 2023.

[7] Source: Bloomberg as of 30 June 2023. Taxable Municipal = Bloomberg Taxable Municipal Bond Index. US IG Corporate = Bloomberg US Aggregate Corporate Index.

[8] Source: Municipal default rates from Moody's Public Finance Report "US Municipal Bond Defaults and Recoveries." Annual data from 31 December 1970 through 31 December 2021 (latest available). US Corporate default rates from Moody's Default and Ratings database. Annual data from 31 December 1970 through 31 December 2021.

[9] Taxable Municipal = Bloomberg Municipal Index Taxable Bonds. US IG Corporates = Bloomberg US Aggregate Corporate Index. Correlation based on trailing 5 years of historical monthly data as of 31 March 2023.

[10] Source: Bloomberg. Daily data from 1 January 2022 through 30 June 2023. Taxable Municipal = Bloomberg Taxable Municipal Index. US Investment Grade = Bloomberg US Corporate Index.

[11] Source: Bloomberg, MFS Research, 30 June 2023.

[12] Source: Bloomberg as of Feb 2023.