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Muni Bonds Aren't Just For Rich Folks

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Believe it or not, municipal bonds can be sexy and exciting. OK, that might be an overstatement. But it's probably not an overstatement to say that many investors view them as dull, straightforward investment vehicles offering low-yielding—if tax-advantaged—interest income that benefits the affluent more than the mass affluent. In reality, while muni bonds are neither sexy nor snoozy, they occupy a lively space within the capital markets and can offer advantages to investors, even if they're not in the highest tax brackets.

"Many people think of bonds, and especially muni bonds, as a sleepy and simple asset class," says Duane McAllister, who says he's contended with misperceptions about these bonds throughout his long career as a fixed-income investment manager. "But it's a complex, broadly diversified market with different types of issuers coming to market at different times with different structures."

The muni bond world is inefficient, he says. That gives active managers the opportunity to generate above-average total returns. And those inefficiencies have guided him and fellow senior portfolio manager Lyle Fitterer in making the Baird Strategic Municipal Bond Fund one of the top performers in its category since it launched in November 2019.

The fund might be young, but McAllister and Fitterer both have more than 35 years of experience managing fixed-income portfolios, with a primary focus on the municipal market. The fund took shape soon after Fitterer joined Baird after a quarter century at Wells Fargo Asset Management (now known as Allspring Global Investments). The two managers run the Strategic Municipal Bond Fund along with six other team members.

Fund research company Lipper earlier this year named the Baird fund as the top short-intermediate municipal debt fund over the past three years. Morningstar listed it as the top performer in its muni national intermediate category in that period. In addition, the fund has earned a top-quartile ranking in that Morningstar category in four of its five years on the market (including year to date as of early October).

Morningstar further praises the fund for the expense ratio on its institutional share class, which at 30 basis points puts it within the least expensive fee quintile among its peers.

Not Always Not Taxable

Municipal bonds are debt instruments issued by governments or other public entities that fall primarily into two main categories: revenue bonds and general obligation (G.O.) bonds, which together make up the vast bulk of the U.S. muni market, valued at $4.1 trillion as of this year's second quarter, according to the Securities Industry and Financial Markets Association. (In comparison, the U.S. corporate bond market was at $11 trillion, and the U.S. Treasury market was $27 trillion.)

Revenue bonds, which make up about two-thirds of the muni market, are backed by revenue streams generated by airports, toll roads, utilities or other projects. G.O. bonds, which are issued by government entities, aren't secured by any asset; instead, they pay bondholders with tax money. Revenue bonds typically

Baird Strategic Municipal Bond Fund

TICKER	BSNIX
ASSETS	$1.4 billion
PERFORMANCE	YTD **3.75%** · 1 yr. **9.93%** · 3 yr. **1.79%**
TOP 5 HOLDINGS	Cass County North Dakota Joint Water Resource District Refunding Improvement Bonds—Series A; Wallkill New York Bond Anticipation Notes; Fort Bend Texas Independent School District Variable Rate Unlimited Tax School Building and Refunding Bonds—Series B; Rosemont Illinois—Series A; New Jersey Turnpike Authority Turnpike Revenue Bonds—Series A
CONTACT INFO	866-442-2473 • bairdassetmanagement.com

BOND CREDIT QUALITY PROFILE (As a % of portfolio)

AAA	12.5%	BBB	12.5%
AA	45.9%	Below BBB	1.7%
A	22.5%	Not Rated	4.8%

SECTOR PROFILE (As a % of portfolio)

Pre-Refunded ETM/U.S. Treasury	5.9%
General Obligation	16.8%
Revenue	75.1%
Cash	2.3%

PORTFOLIO STATISTICS

# Of Holdings	1,151	Turnover Ratio	46.36%
Effective Duration	3.95 yrs	Net Expense Ratio	0.30%

Performance, AUM and portfolio stats as of 9/30/24. Top five holdings as of 8/31/24. Performance and expense ratio figures are for the institutional class shares. Sources: Baird Asset Management and Morningstar.

Manager Duane McAllister

Background As co-lead municipal sector/senior portfolio manager, he plays a lead role in setting investment strategy, with a big focus on municipal portfolio management and credit research. Before joining Baird Advisors, he was a managing director and senior portfolio manager at BMO Global Asset Management, where he was the lead portfolio manager for tax-free fixed-income strategies.

Outside Interests Outdoor activities, reading, being involved with his local church and other nonprofit organizations, and following the Green Bay Packers. He was instrumental in helping to create Grace Landing, a community of group homes for adults with intellectual and developmental disabilities.

Manager Lyle Fitterer

Background As co-lead municipal sector/senior portfolio manager, he plays a lead role in setting investment strategy, with a big focus on municipal portfolio management and credit research. Before joining Baird Advisors, he served as the co-head of global fixed income and the head of the municipal fixed-income team at Wells Fargo Asset Management.

Outside Interests Reading, cooking (especially baked treats for the office), country music, and following local sports teams.

offer higher coupons than G.O. bonds.

There are various nuances to the market that can impact a muni bond's income potential, including the fact that some munis are taxable. But those often offer greater yield to compensate.

The coupons offered by muni bonds are typically lower than those offered by corporate bonds, which are taxable at the federal, state and local levels. Muni bond coupons are somewhat comparable to U.S. Treasurys, which are subject to federal taxes but exempt from state and local income taxes. Most muni bonds are exempt from federal income taxes, which raises their tax-equivalent yield. And they can be exempt from state income taxes as well if the bondholder resides in the state that issued them, further boosting their yield profile.

The pros and cons of munis versus corporates and Treasurys can depend on an individual's tax rate and other financial considerations.

Why Munis, Why Now?

The party appears to be winding down for T-bills, CDs and money market funds, which have been dishing out 5% yields thanks to the Federal Reserve's interest rate hikes in 2022 and 2023. Now that the Fed has started cutting rates, which will reduce the payout from those vehicles, many investors are looking elsewhere for more sustainable yields.

McAllister and Fitterer posit that municipal bonds currently make sense because investors can lock in respectable, tax-adjusted income that is better than what they got for a long period before 2022. As of the end of the third quarter the fund's distribution yield was roughly 3.5%.

"Investors might look at a 3% yield and say, 'That's OK, but it's not very sexy,'" McAllister says. "But if you properly tax adjust it, particularly if you're in a higher income tax rate, it really starts to make a big difference."

Adds Fitterer: "As the rates have gone up, the value of the tax exemption has gone up to an even greater extent." Meanwhile, falling interest rates should translate into higher prices for existing bonds, which will provide capital appreciation and higher total return opportunities for bondholders.

Another plus, the Baird managers say, is the financial health of the municipal securities market. "We're in a period where municipal credits have been about the best they've ever been from a strength perspective," McAllister says. He attributes that to the significant amount of federal aid that state and local governments, as well as various public entities, received as a result of Covid.

"While those funds have largely been spent, we also have had a strong post-recovery backdrop where tax revenues have been rising," he adds. "So you have municipalities today with near-record reserve levels and rainy day funds."

In its August municipal fixed-income market commentary report, Baird cited research from BofA Global Research that said the municipal market was enjoying the longest stretch without a bankruptcy filing (more than 15 months) since at least July 1987.

The final point to consider pertains to future tax rates. While it's always a crapshoot to know what taxes will be in the future, the country's ballooning deficit should be a sign that they'll likely go up rather than down. "It's hard to imagine rates going lower from here," McAllister says. "And it's possible that the corporate and top marginal rates could go up, and if that happens then the value of the tax exemption [on muni bonds] becomes even more valuable."

Investment Universe

Municipal bond opportunities come in oodles of structures and sizes from across the U.S., which is reflected by the variety of holdings found in the Baird Strategic Municipal Bond Fund's portfolio. They run the gamut from the Chicago Board of Education and the airport in Rapid City, S.D., to the Utah Housing Corp. and City of Gulfport, Miss.

When doing its due diligence, the Baird muni bond team examine the financials of new bonds on Bloomberg and the Electronic Municipal Market Access website. They also subscribe to rating agency information and parse research from third-party firms. They'll also pick up the phone to dig deeper into investment opportunities.

"If there's a credit that's new to the market or we need to get up to speed on we'll schedule a conference call with city authorities and municipal representatives and with the investment banker," McAllister says. "One of the fun aspects of this business is lifting the hood to see what makes a particular credit unique."

The fund holds roughly 1,200 issues, but one issuer might account for several bonds. "So in reality we own credits from less than 400 issuers," Fitterer says. "Because there are so many issuers out there and there aren't enough people to look at them, that's what makes the market so inefficient."

Credit Risk

Fitterer says Baird's scoring system puts bonds into three categories: strong credits, core credits and watch credits. Credits placed in the "watch" category tend be bonds rated "BBB" or below. (The lowest investment-grade rating is "BBB-" at Standard & Poor's and Fitch Ratings.)

These lower-rated bonds "have more risk, but they also have more income or total return potential," he says. "The risk/reward for doing that has been very good when you look at default rates historically. A BBB-rated muni bond historically has had a default rate lower than a AAA-rated corporate bond. So it's a great place to take credit risk."

But taking credit risk doesn't necessarily translate into a riskier fund. Morningstar rates the Baird fund as below average risk for its category. Bond investing can be a tricky thing, which is why many investors prefer to rely on professional managers for their fixed-income allocation, perhaps through mutual funds or separately managed accounts. Index-based bond exchange-traded funds have been a popular option for many investors, but some people argue they aren't nimble enough to quickly maneuver when market conditions or interest rates change.

The Baird fund's managers say it offers a combination of better liquidity and greater diversification than what individual investors, or even separately managed accounts, can achieve. They also claim they can generate a higher yield by creating portfolios that include lower-quality bonds within a higher-quality portfolio (the fund's average credit quality is generally "AA-" to "A+").

McAllister says munis as an asset class can complement an overall fixed-income allocation. "They perform differently at different points in the cycle, so it helps create a nice balance," he says.

"If you pay no income tax, then obviously you shouldn't be in munis," he continues. "But if you're a tax-paying investor of any sort, I think it makes sense to look at the muni fund and to think of it as a diversifier because munis tend to lag in the economic cycle—corporate spreads will widen out and corporate credits will get hurt first in a slowdown, whereas munis will lag, and that'll help you in those situations."

Opinions and estimates contained in this article are subject to change without notice, as are statements of financial market trends, which are based on current market conditions. This article originally appeared on *Financial Advisor* magazine's website on November 1, 2024

Important Disclosure Information

Baird Strategic Municipal Bond Fund inception date: 11/15/2019

The performance data quoted represents past performance. Past performance does not *guarantee future results. Investment returns and principal value will fluctuate and shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the data quoted. To obtain the most recent month-end performance data available, please visit bairdfunds.com.*

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The gross/net expense ratios (%) for the fund are .30/.30. Investment results assume all distributions are reinvested and reflect applicable fees and expenses. Investor class expense ratios include a 0.25% 12b-1 fee.

Because the Fund may invest more than 25% of its total assets in municipal obligations issued by entities located in the same state or the interest on which is paid solely from revenues of similar projects, changes in economic, business, or political conditions relating to a particular state, or types of projects may have a disproportionate impact on the Fund. In a rising interest rate environment, the value of fixed-income securities generally declines and conversely, in a falling interest rate environment, the value of fixed income securities generally increase. High yield securities may be subject to heightened market, interest rate or credit risk and should not be purchased solely because of the stated yield. Municipal securities may or may not be appropriate for all investors, especially for those in lower tax brackets. All investments carry risk, including loss of principal.

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