

# Municipal High Yield 101

## Understanding the Basics of the Municipal High Yield Market

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*The high yield municipal bond market has been steadily growing over the past decade. This asset class is an important part of the overall municipal bond market and offers many potential benefits for investors looking for tax-advantaged investments. Pioneer portfolio manager Timothy Pynchon calls on his 26 years of investment management experience to answer some commonly asked questions about investing in the municipal high yield market.*

### **Q. What's the difference between investment grade municipal bonds and high yield municipal bonds?**

**A.** Investment grade municipal bonds are largely comprised of bonds issued by cities, states and municipalities worthy of an investment grade rating to fund capital projects, such as the construction of schools, roads and bridges, airports, and the like. High yield municipal bonds are typically issued by government entities acting solely as a conduit to finance economic or industrial development, housing, environmental projects, and retirement care facilities. Many high yield muni bonds are issued by those same government entities on behalf of not-for-profit organizations. High yield bonds – also known as high income bonds or “junk” bonds – commonly rely upon the revenues and profitability of the individual entity receiving the money raised through the bond issue. For instance, if a bond is issued on behalf of a nursing home, the successful repayment of that bond lies squarely upon the nursing home’s ability to repay the debt. So the term municipal bond is something of a misnomer, but is industry parlance used to describe all tax-exempt bonds. With both types of bonds, interest payments are exempt from federal taxes, and in some cases, state taxes. A key difference between the two types of bonds is that high yield muni bonds, by definition, have below investment grade credit ratings but pay higher interest rates as a result.

### **Q. Why should investors consider “junk” municipal bonds?**

**A.** While high yield municipal bonds carry more investment risk than investment grade municipal bonds, they generally provide a higher coupon and the opportunity for capital appreciation. This can be a potent combination for investors over time. But high yield muni bonds typically are complex, and many have a speculative element to them. For example, a given bond issue might finance the development of a new prison or airport terminal, but there is no guarantee the project will be successful. We need to evaluate everything from construction risk and lease-up

risks to the ability of the facility to repay its debt. If done correctly, however, the prices of these bond issues can appreciate in value if the project’s revenues exceed projections over time. In some cases, unrated bonds can become rated, or rated bonds can be upgraded, or an issuer might refinance the project with better terms and take out the existing bonds. All of these scenarios can lead to significant capital appreciation for the bonds. This aspect of the high yield muni bond asset class has been a key reason why they have generated historically higher returns than investment grade muni bonds. Despite their higher risk profile, high yield muni bonds have a historic default rate of approximately two percent, so the trade off between risk and reward is attractive. The combination of the tax benefit of high yield muni bonds and the low default rates relative to corporate bonds with similar credit ratings is a major draw for tax-paying investors that are seeking tax relief. Generally speaking, the investment-grade muni bond universe tends to be more predictable and less volatile.

### **Q. What are the determining factors in defining a bond as a high yield municipal bond?**

**A.** A bond is defined as being high yield if it is rated below investment grade, or BBB-, or is simply non-rated. In exchange for accepting an unrated bond, investors are paid a premium in the form of a larger coupon. That is the technical definition. The fact is that the high yield universe is full of both good and bad projects, and the challenge, of course, is to determine which is which. There are also credits that enter into the high yield universe by failing to maintain their investment grade ratings, and thus fall from investment grade to below investment grade. These are the so-called “fallen angels”. A good example is airline and airport bonds which were once high flying but have since been grounded with all the problems that have plagued the airline industry.

**Q. How do fallen angels impact a high yield municipal bond fund's potential for total return?**

**A.** Depending upon the individual credit and its story, fallen angels often represent exceptional value for the fund. For instance, if the credit has fallen from grace but has subsequently stabilized and is improving, the price of the bonds in the secondary market can increase in value, creating an opportunity for capital appreciation. Fallen angels can represent extraordinary opportunities to find higher yields for strong credits that simply need time to work out specific problems. Of course, this does not apply to all fallen angels, which is why extensive credit research becomes so important to municipal bond investors.

**Q. How do investors know whether a high yield municipal bond fund represents an appropriate level of risk?**

**A.** Experienced municipal bond investment managers use a variety of approaches to closely evaluate individual issues and assemble portfolios that they believe will have the best risk-reward profile. Generally speaking, each high yield muni bond issue needs to be assessed based on a variety of factors such as the track record of the issuer, the likelihood of projected revenues being realized, the value of collateral assets, and the quality of management. For investors, one of the most important considerations is the track record of the investment manager and the depth of the resources they can bring to bear in researching individual issues.

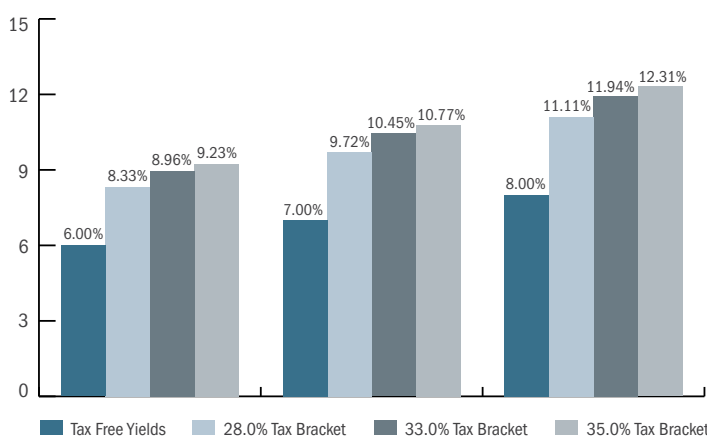
**Q. What are the benefits of investing in a high yield municipal bond fund rather than adding one or two individual high yield bonds to a higher quality municipal bond portfolio?**

**A.** As the old adage says “don’t put all of your eggs in one basket.” Investing in a high yield municipal bond fund helps investors avoid this pitfall. The high yield market is too risky and too dynamic to make a bet on just one or two bonds. For instance, over the past couple of years we have seen the airline industry, which is the source of many tax-exempt bonds and was a stalwart year after year, unravel, with enormous price volatility. For an individual who held one or two airline bonds, the effects would have been devastating. In the context of a well-diversified fund, however, those negative effects may have been mitigated. A credit that is financially sound today may not be financially sound tomorrow. Continuous analysis of a wide variety of credits and sector trends is critical to the construction of a balanced and well-diversified portfolio, as well as buy and sell decisions. Investing in high yield municipal bonds requires a great deal of expertise and most individual investors aren’t equipped to invest directly in these issues because of the difficulty in evaluating their risks and the ongoing monitoring that is required to protect one’s investment.

**Q. How do interest rates impact the performance of a high yield municipal bond fund?**

**A.** High yield municipal bonds are less sensitive to interest rate moves than investment grade bonds. That is because rising rates generally occur when the economy is expanding – businesses are growing, cash flows are improving, and the outlook for the credits into which these funds invest are improving as a result, both from a rating and financial perspective. Remember, all we are really investing in are businesses that comprise the economic fabric of the U.S., including education, healthcare, and transportation. All of those are essential needs in the U.S. So as a general rule, as the economy goes, so go these businesses.

**Tax Free Yields and their Equivalent Taxable Yields at Different Tax Brackets**



Source: Pioneer research. This chart is hypothetical and intended for illustrative purposes only. Yields are not intended to represent those of any Pioneer mutual fund.

**Q. What can a high yield municipal fund add to an all-equity portfolio?**

**A.** Diversification for any portfolio is of the utmost importance, and investing in a high yield municipal fund is one way to look for higher yields while diversifying your portfolio. High yield municipal funds also offer some other compelling advantages to investors. For instance, high yield municipal bonds have historically had very low correlation to other asset classes, including equities and treasuries, so they can be great portfolio diversifiers. In the event that equities experience a correction, high yield municipal bonds may be only marginally affected. In addition, the historic default rates for high yield municipal bonds have been minimal so the risk/reward potential, when one considers the historic returns, is compelling.

**Q. Considering the risk they carry, why do the yields for high yield municipal funds seem lower than other fixed income products?**

**A.** High yield municipal fund yields seem lower because they are reported on a tax-exempt basis, so it is critical to measure like-yields. An investor should understand how to compare returns on a high yield municipal fund to those of a taxable bond. Our experience is that when the two yields are compared on a like basis that the high yield muni returns look very attractive.

**Current Yields**

<b>Current Yields as of 10/31/11</b>	<b>10.91%<sup>1</sup> (Tax Equivalent) 7.09%<sup>2</sup> (Tax Free)</b>	<b>8.10%<sup>3</sup> (Taxable High Yield)</b>
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<sup>1</sup>Taxable equivalent yield calculated for 35% tax bracket as of 10/31/11.  
<sup>2</sup>High Yield Municipal Bond Yield represented by Lehman Brothers High Yield Municipal Index.  
<sup>3</sup>Taxable Corporate Bond Yield represented by Bank of America High Yield Master II Index as of 10/31/11.

**Q. What is Pioneer Investments' approach to high income municipal fund investing?**

**A.** Our investment philosophy involves two key elements: first, we are value investors, and our intention is to buy and hold. Second, we are credit driven, which we believe is critical to achieve returns. We keep our eye on several areas,

such as duration, average life, sector weightings, and the benchmark indices, but our primary objective is to find good credits presenting good relative value in the market that will lead to a stable and well diversified portfolio year after year. Additionally, Pioneer Investments believes in constructing a diversified portfolio from both a credit and geographical standpoint to mitigate the higher risks associated with high yield bonds.

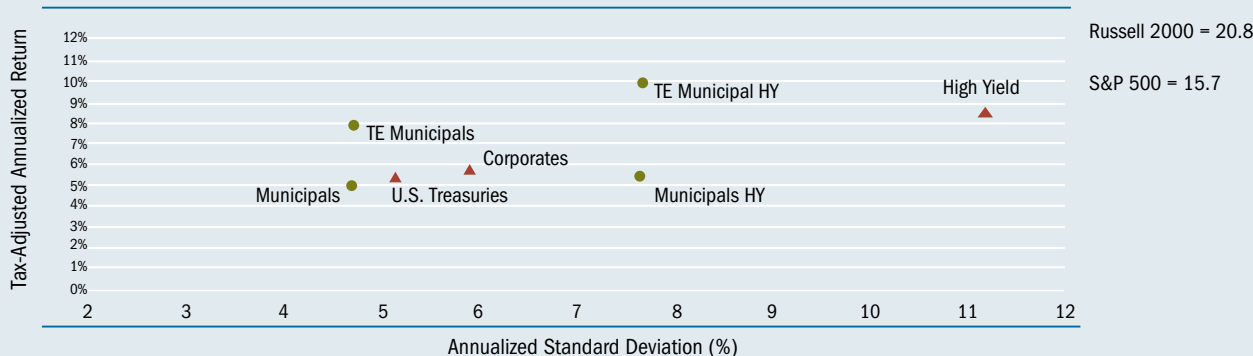
**Q. Who should invest in a high yield municipal fund?**

**A.** It's important to remember that the decision to buy a high yield municipal fund is one of risk and return. Historically, the municipal high yield asset class has generated strong returns without taking on undue amounts of risk (see chart below). For those willing to bear that added risk, a high yield municipal bond fund may offer a good source of tax exempt income as well as an element of overall portfolio diversification, and I believe it may be appropriate for a wide variety of investor portfolios. Of course, individual investors should consult with a financial advisor to determine if these types of investments are right for them.

**Timothy Pynchon** has over 26 years of investment management experience in high yield credit analysis, both corporate and municipal. The Lead Portfolio Manager for the Pioneer High Income Municipal Fund, he's been a member of Pioneer's municipal bond investment team since 2000.

**High Yield Municipal Bonds: Favorable Risk Return Ratio Over Time**

Comparison of Taxable Equivalent Returns and Volatility of Municipal Bonds vs. Other Asset Classes (Past Ten Years Ending September 30, 2011)



Source: Barclays 9/30/11. **The performance data quoted represents past performance, which is no guarantee of future results.** \*U.S. Treasury income returns are exempt from state income taxes and adjusted (3.25% in 2002-2007, 3.23% in 2001 and 3.18% prior) using a national state average (top bracket), net of Federal income tax. \*TE Munis is based on an equally weighted national average Federal and State (top bracket) income tax rate (38.45% for 2003-2007, 41.85% for 2002, 42.33% for 2001 and 42.78% prior – local taxes have not been considered in the analysis. Municipals HY is represented by The Barclays High Yield Municipal Index, which includes bonds rated Ba1 or lower or non-rated bonds using the middle rating of Moody's, S&P and Fitch. Municipals is represented by The Barclays Municipal Index, which has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds (including all insured bonds with an Aaa/AAA rating), and prerefunded bonds. Corporates is represented by The Barclays U.S. Corporate Index, which is the largest component of the US Credit Index and includes dollar-denominated debt from U.S. and Non U.S. industrial utility and financial institution issuers. U.S. Treasuries is represented by The Barclays U.S. Treasury Index, which includes public obligations of the U.S. Treasury that have remaining maturities of one year or more. High Yield is represented by The Barclays U.S. High Yield Index, which covers the universe of fixed rate, non-investment-grade debt. The Index was introduced in January 1986, with historical data available from January 1983. The Standard & Poor's 500 Stock Index (the S&P 500) is a commonly used measure of the broad U.S. stock market. The Russell 2000 Index is a measure of the performance of U.S. small-cap stocks. Indices are unmanaged and their returns assume reinvestment of dividends and, unlike mutual fund returns, do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index. Standard deviation is a statistical measure of the historic volatility of a portfolio.

**Before investing, consider the product's investment objectives, risks, charges and expenses. Contact your advisor or Pioneer Investments at 1-800-225-6292 or visit [pioneerinvestments.com](http://pioneerinvestments.com) for a prospectus (or summary prospectus, if available), financial statements, or the most recent month-end performance results. Read them carefully before you invest.**

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#### **A Word About Risk**

Investments in high yield or lower-rated securities are subject to greater-than-average risk.

When interest rates rise, the prices of fixed-income securities in the Fund will generally fall. Conversely, when interest rates fall, the prices of fixed-income securities in the Fund will generally rise.

A portion of income may be subject to local, state, federal and/or alternative minimum tax.

Capital gains, if any, are subject to capital gains tax.

Investments in the fund are subject to possible loss due to the financial failure of issuers of underlying securities and their inability to meet their debt obligations.

Prepayment risk is the chance that mortgage-backed bonds will be paid off early if falling interest rates prompt homeowners to refinance their mortgages. Forced to reinvest the unanticipated proceeds at lower interest rates, the Fund would experience a decline in income and lose the opportunity for additional price appreciation associated with falling interest rates.

At times, the Fund's investments may represent industries or industry sectors that are inter-related or have common risks, making it more susceptible to any economic, political, or regulatory developments or other risks affecting those industries and sectors.

These risks may increase share price volatility.

Diversification does not assure a profit or protect against loss in a declining market.

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