Muni Bonds Deserve a Greater Role in Investors' Portfolios

Baird Advisors

Baird Funds

Municipal bonds have long been a favorite for tax-sensitive investors, offering the unique advantage of federal—and often state—tax exemption on interest income. While investors have historically chosen munis for their tax benefits and relative safety, the current market environment presents an especially compelling case to increase allocations to municipal bonds. Despite lagging returns year-to-date, several powerful factors suggest now is an opportune time to revisit and potentially overweight municipal bonds in a diversified portfolio.

Recent Performance: Municipal Bonds Have Lagged, Creating Opportunity

As of August 31, 2025, the Bloomberg Municipal Bond Index posted a modest total return of just 0.32%. By contrast, the Bloomberg U.S. Aggregate Bond Index, which tracks the broader taxable bond market, delivered a robust 4.99% return over the same period. This divergence in performance can be traced in part to technical pressures in the municipal market, including heavy supply and shifting investor sentiment.

While underperformance may discourage some, history suggests that periods of lagging muni returns can set the stage for attractive entry points. When valuations in the municipal market become more compelling relative to taxable bonds, forward-looking investors have the opportunity to capture additional yield and benefit from a potential snap-back in returns as market conditions normalize.

Tax-Advantaged Returns: Systematic Outperformance for Most Investors

According to a recent *Wall Street Journal* article (WSJ, 9.3.25, "Tax-Exempt Munis vs. Taxable Bonds: Which Has Higher Returns?"), the data over the past 15 years is clear: for most investors, especially those in higher tax brackets, municipal bond funds have consistently delivered higher after-tax returns than their taxable counterparts.

- General Muni Funds: Over the past 15 years, the average municipal bond fund delivered a post-tax annualized return of 3.32%, compared to just 1.54% for similar taxable bond funds. Volatility was comparable, at 6.33% for munis versus 5.11% for taxable bonds.
- Intermediate-Term Munis: The advantage persists for intermediate-term funds, with muni bond funds returning 2.53% post-tax annually, outpacing taxable bond funds at 1.72%. Again, risk levels were similar.
- Short-Term Munis: Even in the short end, municipal funds edged out taxable funds with a 1.32% post-tax return versus 1.25%.

The research underscores that, unless an investor's marginal tax bracket is less than 30% and focused on short-term debt, munis are the superior after-tax choice. Even assuming a marginal tax rate as low as 10%, municipal funds have delivered better after-tax results, thanks to their tax exemption on both federal and often state levels.

Technical Tailwinds: Abundant Supply and Market Accessibility

Another compelling argument for municipal bonds today is the record-breaking supply currently available. Municipal issuance is running approximately 20% ahead of last year's already high pace. For investors, this abundance means more choice, better liquidity, and, frequently, the ability to secure more attractive yields as issuers compete for capital.

With so much new paper coming to market, investors are finding opportunities not only in traditional general obligation and revenue bonds, but also in more niche sectors such as healthcare and education-related financing. This surge in supply has contributed to the temporary performance drag but also means that spreads and yields are more attractive on a relative basis, further improving the potential after-tax return for new buyers.

Policy Clarity: The Passage of OBBBA

Uncertainty around tax policy often casts clouds over municipal markets as future changes could alter the relative attractiveness of tax-exempt income. However, with the recent passage of the OBBBA (Omnibus Bipartisan Budget and Benefits Act), investors now have greater clarity regarding tax treatment moving forward. This policy stability reduces one of the key risks to the municipal sector and should enhance investor confidence, potentially attracting new buyers and supporting price appreciation.

The Strategic Advantage of Municipals Now

The case for investors increasing their allocation to municipal bonds today is stronger than it has been in years:

- Recent underperformance relative to taxable bonds has left munis attractively valued, creating an entry point for tax-sensitive investors.
- Extensive historical data confirms that munis have consistently delivered higher after-tax returns for most investors, especially those in higher tax brackets, across various maturities and risk levels.
- Record municipal issuance provides ample choice and, in many cases, higher yields, enabling investors to be more selective and potentially lock in better tax-adjusted returns.
- Legislative clarity on tax policy reduces market uncertainty and makes the predictable income stream from munis even more attractive.

For investors seeking to enhance after-tax returns, diversify fixed income exposure, and benefit from both current technical and policy tailwinds, increasing allocation to municipal bonds is not only a prudent choice—but a timely one. As always, investors should consider their own tax situation and consult with a financial advisor, but the data and the market environment suggest that munis deserve a prominent place in portfolios today.