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Making Sense Of The Muni Bond Market

Tom Collimore, 07.30.10, 3:04 PM ET

The municipal bond market has over the past few years gone through its most tumultuous period in decades. State and local governments are under enormous stress. Bond insurers have flirted with insolvency. And a new form of taxable municipal debt, known as Build America Bonds, has emerged.

Following are excerpts from a discussion about the muni market conducted by Tom Collimore, director of investor education for the CFA Institute. Joining him are Paul Jungquist, CFA and Senior Portfolio Manager, SIT Mutual Funds, Steve Klein Principal, First Infrastructure Consulting and Kurt van Kuller, CFA, Director of Institutional Sales, Northeast Securities and former Manager of Municipal Credit Research, Merrill Lynch.

Collimore: Let's begin with a description of what municipal bonds are.

Van Kuller: The municipal bond market has about $3 trillion worth of debt outstanding at present. It's about as broad as the corporate bond market, if not more. There are general obligation bonds, which are backed by the creditworthiness of the cities, states and other issuers, plus many sectors of revenue bonds and project financings, including those backed by utilities, hospitals, universities, transportation authorities, housing, tobacco settlements and special assessments.

Historically, muni bonds have defaulted less frequently than corporate bonds. Is that trend likely to continue?

Van Kuller: In my view, yes. Local governments do not disappear. They have far less event risk [than corporate issuers]. Bankruptcies are extremely rare for municipalities. George Hempel did a study in which he determined that about 3,000 muni bonds defaulted during the Great Depression. That represented about 15% of the muni debt outstanding at the time, but investors ultimately recovered 99% of their investments.

Paul, looking at the market from the buy-side, do you have any particular concerns about the credits out there?

Jungquist: General obligation issuers are facing greater challenges than they have in the past with respect to retiree pension and health care obligations. The ability to raise taxes remains, but doing so is, I think, more difficult today than it has been in the past.

I understand that ratings have been remapped at Moody's and Fitch. What does that mean for retail investors?

Jungquist: It's widened the "band" of credit quality within the various rating categories, so credit analysis is going to be more important than it has been. Also, ratings are generally higher than they have been, so reporting on a historical basis is going to be more difficult.

Should investors take comfort in the fact that some muni bonds are backed by private insurance?

Jungquist: Legacy insurers still have considerable claims-paying ability, so I think in the short to intermediate term that insurance is still valuable to investors, but if they're unable to write new business going forward, they're not going to generate revenues to pay many years down the line. It's also notable that the muni market itself is treating insured debt as of no greater value than uninsured debt.

Klein: I think the industry is on life support. There is only one active financial guarantor in the market, and its share of

writings seems to be in a state of decline. The likelihood is remote that any of the rating agencies will upgrade any entity in this space to levels where investors really care.

Collimore: How do muni bonds fit into a retail investor's portfolio?

Jungquist: Owning municipal bonds is one of the most important tax-advantaged strategies that an individual investor can use. It's also important to note that historically tax-exempt bond prices have been far less volatile than the prices of virtually any other investment.

Collimore: How do you create diversification within a muni portfolio?

Jungquist: One of the best ways is to invest in a mutual fund. Otherwise, you need to shop around, not only with the large Wall Street firms but also with regional firms to get a good mix of bonds. It takes some effort to get that kind of diversification.

Klein: I think the mutual fund approach is a better way to ensure diversification. The notion that an investor has the choice between buying bonds directly in an efficient way and investing in mutual funds is a bit of a false proposition. As a practical matter, that's not something a retail investor is likely to do, has any idea of how to do or is motivated to do.

Van Kuller: I think the science of credit analysis in munis is something best left to professionals. As we had mentioned at the outset, the municipal market has become much more complex, and there's really not a plain-vanilla area for the majority of bonds. For the high-net-worth investor, some very reputable firms offer managed accounts that provide the same type of expertise used in mutual funds but tailored to the investor's specific needs.

Collimore: What if you're concerned about inflation?

Jungquist: What makes sense is to have a portfolio with regular cash flows: bonds with sinking fund payments or housing bonds that provide prepayments. That allows the investor to reinvest at higher rates as they come along. Floating-rate bonds would certainly also provide a very good hedge against inflation. The instinct is to be very short in duration if you're worried about inflation, but today, because short rates are so low, you're losing money by investing in the short to intermediate term.

Collimore: Are there any large looming credit risks out there that give you particular pause?

Van Kuller: Some community development district bonds in Florida, known anecdotally as "dirt bonds," are under severe distress. It's estimated as much as $3 billion have defaulted, with another couple of billion more looming. This is a small niche of municipals.

Klein: And in all likelihood an entirely unrated niche.

Van Kuller: Exactly, the unrated, high-yield area. I think there's a great deal of negative press involving municipal credits. Some have compared it with what's happening in Europe, but there you're measuring debt and deficits against gross domestic product. Here, we're measuring against the budget gap, and there's a tremendous difference in scale. California has a gross state product of about $1.8 trillion and a general fund budget of a little over $80 billion. The gap for fiscal 2011 is about $19 billion. That's pretty significant in an $82 billion budget, but compared to gross state product, it's a modest 1%. In Europe, you hear of deficits like 8% to 12% of GDP.

Collimore: Should muni bond investors factor in the potential effects on their alternative minimum tax liabilities?

Van Kuller: Certain muni bonds can trigger additional tax liabilities because they're subject to the alternative minimum tax, but AMT bonds are easily avoided. They're less than 10% of outstanding bonds, and Congress has removed the AMT from all new issues. But if you're certain you're not subject to the AMT, they can provide a nice yield pickup because they carry a higher coupon.

Collimore: What are Build America Bonds?

Klein: Build America Bonds are taxable bonds issued by states or local issuers in which a portion of the taxable interest is reimbursed to the issuer by the federal government. They've drawn a new class of investor into the muni bond market. This has eased some of the supply pressure on the more traditional side of the market, resulting in relatively attractive interest rates. As a feature of the federal stimulus bill, Build America Bonds are currently up for renewal or extension. The terms are still under discussion.

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