MARKETS & ECONOMY

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What's causing the slump in muni bond ratings?

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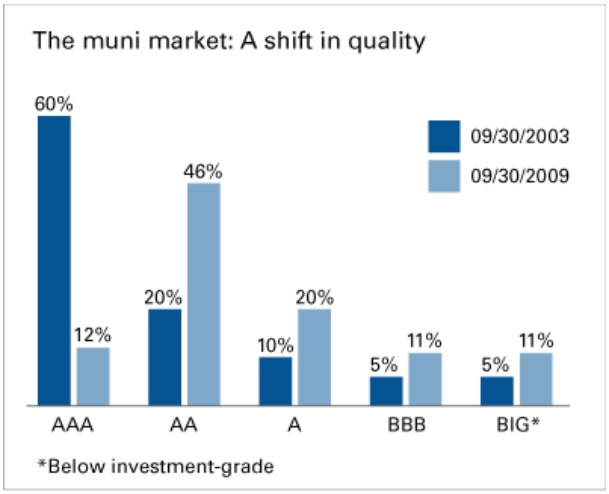
In recent years, the municipal bond market has experienced a dramatic downward shift in credit ratings. In 2003, 60% of all muni bonds enjoyed "triple-A" ratings; as of September 30, 2009, AAA bonds were down to just 12% of the market.

We asked Chris Alwine, head of Vanguard's municipal bond fund operations, what's behind this change—and what it means for investors.

What's happening in the muni market?

Even though municipal bonds have performed very strongly this year, there's been a market-wide downgrading in credit ratings. As you can see here, as recently as 2003, AAA-rated bonds made up the lion's share of the market. Today, they're only a small fraction. The biggest gain has been in the AA bracket, which has more than doubled. All other segments have seen similar gains.



Sources: Barclays Capital, Moody's Investor Services, and Vanguard.

What caused this shift?

There are 2 factors at work. By far the most significant is the downgrading of bond insurers. When you invest in an insured bond, you take some comfort from knowing that if the bond issuer is unable to pay, the insurer will step in and provide timely payment on your investment. When a bond is insured, the bond takes on the credit rating of the insurer or the issuer, whichever is higher.

Unfortunately, in recent years many insurers branched out into insuring products like subprime residential mortgages. When the housing market collapsed and losses in these mortgage securities grew, bond insurers were on the hook for timely payment of both interest and principal. The insurers' losses eroded their capital position, and accordingly, the insurers' credit ratings were downgraded. Since most issuers on their own were rated below the insurer's AAA rating, their bonds were downgraded when the insurer was cut below AAA.

At the same time, the overall slowdown in the U.S. economy has hit states and municipalities quite hard. (California comes immediately to mind, but it's just one example among many.) When a government is faced with large budget deficits, its perceived creditworthiness will generally suffer.

What does this mean for muni bond investors?

Munis have enjoyed a good year, thanks primarily to the Federal Reserve's forceful efforts to loosen up the credit markets. Munis were extraordinarily cheap relative to Treasuries earlier in the year, but they've rallied back and are close to what we would consider normal yields.

Still, given the budget challenges that most state and local governments face, it's fair to say that the average municipal bond investor is taking on a little more risk these days. That means credit quality probably ought to be a more pertinent factor in any investment decision. The bottom line is that investors should be prepared to research the credit quality of the bonds they own or are considering purchasing.

"Understandably, the credit-rating shift we've seen in the market at large is reflected in our funds, but we're confident that the muni market is in solid shape. We still believe in munis."

For Vanguard, not much has changed. We have a team of seasoned bond analysts who look very carefully at the credit quality of the securities held in our funds, both in terms of the underlying issuers and the insurers. Understandably, the credit-rating shift we've seen in the market at large is reflected in our funds, but we're confident that the muni market is in solid shape.

Does this added risk underscore the need for diversification?

Absolutely. Diversification is important for any investor, regardless of market conditions, but a situation like this illustrates the importance of managing risk by diversifying your portfolio. But, as I said, we're still confident in the long-term strength of the municipal bond market. We still believe in munis.

Do you expect to see a shift back toward triple-A ratings?

Not in the immediate future. State and local governments are likely to remain under fiscal stress for the next several years, in which case the downward credit pressure could continue. Of course, if we experience strong, sustained economic growth, the budgetary stress would be reduced.

Notes:

- Past performance is no guarantee of future results.
- All investments are subject to risks. *Investments in bonds are subject to interest rate, credit, and inflation risk.*
- Diversification does not ensure a profit or protect against a loss in a declining market. U.S. government backing of Treasury or agency securities applies only to the underlying securities and does not prevent share-price fluctuations.