Municipal Bond Worries

In 2010, prominent industry analysts warned of a looming fiscal crisis among state and local governments. Some experts even predicted widespread municipal bond defaults in the US.[1] Investor fears intensified in late 2010 when the municipal bond market experienced one of its largest selloffs in decades, which drove up bond yields.[2] While factors unrelated to credit concerns may have contributed to the selloff, some investors were motivated by a perception of rising credit risk among municipal bond issues.[3]

So, is the municipal bond market at risk for widespread default? No one knows—and we are not in the prediction business. But your view probably depends on your economic expectations and familiarity with the municipal bond market. With this in mind, consider these principles:

- **The municipal bond market is large and diverse.** The media often report on municipal bond problems as though the market is a single, uniform sector. In reality, the market comprises an estimated $3 trillion in debt, with about 55,000 state and local issuers and approximately 2 million outstanding issues. These bonds are rated across a broad spectrum of credit categories and have different characteristics and structures for paying their obligations. Such complexity does not afford simple observations about the market.

- **Historical default rates are low.** Muni bonds have a strong track record of repayment. One reason is that state and local governments are motivated to avoid default since failure to pay affects their ability to raise capital in the future. Another reason is that most issues repay investors from either project revenues or from a general fund backed by the taxing power of the issuer. Chart 1 shows default rates for municipal and corporate bonds in the US from 1970 to 2008. There have been no defaults in the top-rated investment grade tier (Aaa/AAA). Most defaults are limited to the non-investment grade universe.

Chart 1: Bond Default Rates—Cumulative Percent (1970–2008)

	Moody's		Standard & Poor's	
Rating Categories[1]	Municipal	Corporate	Municipal	Corporate
Aaa/AAA Bonds	0.00	0.52	0.00	0.60
Aa/AA Bonds	0.06	0.52	0.00	1.50
Investment Grade	0.07	2.09	0.20	4.14
Non-Investment Grade	4.29	31.37	7.37	42.35

1 Aaa/AAA indicate top-rated investment grade bonds; Aa/AA bonds represent the lower part of the upper-half tier of investment grade. Moody's ratings for the full range of investment grade bonds are Aaa, Aa, A, and Baa; Standard & Poor's and Fitch investment grade ratings are AAA, AA, A, and BBB. Non-investment grade ratings are all ratings below Baa and BBB.

Source: Municipal Securities Rulemaking Board (MSRB)

Of course, these historical default rates may not be so low in the future, especially if fiscal conditions prove worse than in the past. Investors also should consider the potential for local government bankruptcy. Federal bankruptcy law enables local governments to file for Chapter 9, although some states do not permit these filings and provide alternative means for their distressed local governments to adjust debts. As sovereign entities, states cannot file for bankruptcy protection. But some lawmakers are considering ways to enable financially distressed states to seek bankruptcy protection versus requesting a federal bailout.[4]

- **Most fiscal problems are reportedly concentrated in a few large states.** An estimated 58% of the recent budget shortfalls have occurred in five states: Arizona, California, Illinois, New York, and Texas.[5] Moreover, current levels of state and local government debt, as well as interest payments on that debt, remain well within the historical range.[6] However, beyond the short-term budget gaps, many local and state governments face deep structural problems, including unfunded pension liabilities that could consume a growing share of their budgets. Research estimates that these pension obligations may be considerably higher than what states are reporting under Governmental Accounting Standard Board (GASB) rules.[7]

- **Municipal bonds are assessed according to actual financials, not models or projections**. Some reports have compared the municipal bond market to the subprime mortgage securities market prior to the financial crisis. The circumstances are different in some ways. Municipal bonds are not exotic instruments with complex structures that obscure the underlying credit rating and market value of the assets.[8] As a result, munis are generally more transparent than the mortgage derivatives that helped spark the financial crisis. Also, state and local issuers are subject to financial disclosure rules, and the information they provide affects the market prices and credit ratings of their bonds. Unfortunately, municipal bond reporting is not as timely or thorough as financial reporting on corporate debt. According to the Securities and Exchange Commission (SEC), about 20,000 of the 55,000 borrowers in the municipal market do not adhere to GASB standards. Consequently, lawmakers are pushing for improved accounting standards and reporting rules to increase transparency for investors and market participants.[9]

- **Current market conditions do not imply unusually high risk**. The market incorporates information and expectations into prices, including perceived risk, as illustrated by rising bond yields during the financial crisis and in the recent municipal market selloff. However, since the start of the recession in November 2007, average yields for the AAA, AA, and BBB rated municipal securities have fallen.[10] Also, total market volume as measured by total number of trades has been generally flat over the last three-year period.[11] Chart 2 features the municipal bond indexes of several large states with reported budget problems, as well as US Treasury and corporate bond indexes (rated AAA through BB). Although slightly higher, the estimated tax-adjusted municipal bond yields are within range of corporate indexes with comparable average credit ratings. This may reflect higher perceived risk, but also differences between state tax rates and other factors influencing investor preferences.

Chart 2: US Bond Index Yields
State Municipals, Corporates, and Treasuries
As of April 26, 2011

Bloomberg US Municipal Bond Indexes (3-Year)[1]	Average Credit Rating	Estimated Duration	Highest 2011 State Tax Rate	Yield	Tax-Adjusted Yield[2]
Illinois	AA	2.9	5.00%	3.00	**4.86**
California	A	2.9	10.30%	1.83	**3.14**
Florida	AA	2.9	0.00%	1.39	**2.14**
New York	AA	2.9	8.97%	1.24	**2.10**
Texas	AA	2.9	0.00%	1.13	**1.74**

BofA Merrill Lynch US Bond Indexes (1-5 year)[3]	Average Credit Rating	Estimated Duration	Highest 2011 State Tax Rate	Yield	Tax-Adjusted Yield[2]
Corporates, Cash Pay, BB Rated[4]	BB	2.7	–	**5.26**	–
Corporate-BBB Rated	BBB	2.8	–	**2.80**	–
Corporate-A Rated	A	2.7	–	**2.16**	–
Corporate-AA Rated	AA	2.7	–	**1.92**	–
Corporate-AAA Rated	AAA	2.9	–	**1.76**	–
US Treasuries	AAA	2.5	–	**0.94**	–

1. US Municipal Bond Indexes represent all general obligation issues in the respective state.
2. Tax-adjusted yield represents equivalent yield after adjusting for exemption from federal and state taxes. Federal tax rate assumed to be 35%. State taxes are shown in Highest 2011 State Tax Rate column. Yields take into account the deductibility of state taxes on investor federal tax returns.
3. The 1-5 year bond indexes are used because their estimated durations approximate those of the 3-year municipal bond indexes.
4. Index represents 3-5 year maturity.

Risk Management Issues
Investors should always consider ways to manage risk in their fixed income portfolios. Here are a few guiding principles:

- **Hold shorter-term issues.** This approach may help reduce volatility while enhancing liquidity. Also, fixed income investors who hold investment grade bonds must consider their exposure to changes in interest rates. Bond prices move in the opposite direction of interest rate changes—and the longer a bond's maturity, the greater its price change.

- **Stay broadly diversified.** Holding many municipal bond issues and avoiding concentration in a particular state, sector, or issue type can help reduce the impact of a few non-performing bonds. If default rates rise, investors with a well-diversified municipal portfolio should be less exposed.

- **Focus on quality and use market pricing to confirm credit ratings.** The most creditworthy bonds are those rated AAA or AA, and most of the current problems involve lower-rated bonds. Although ratings are useful, recent history in the mortgage-backed securities market has shown that a bond may not be rated accurately. A bond that is rated AAA should trade in a similar price range to other bonds with similar characteristics and a comparable rating.

Portfolio Decisions
Investors can either hold a portfolio of individual municipal bonds or buy shares in a fund. Building a portfolio of individual bonds offers more direct control over maturity, face value, bond type, credit range, and other issue characteristics. This approach may be useful for matching future liabilities and pursuing other investment objectives. But achieving broad diversification with a custom portfolio may prove a challenge, and the portfolio may be less liquid and expensive to trade, and require more attention and oversight than is feasible for an individual.

Investors often favor professional fund management for many reasons, including enhanced diversification at a reasonable cost and those specific to the way the bond market operates. Since bonds are traded through a network of dealers and not a centralized exchange, price discovery may not be easy. Muni bonds also tend to be less liquid than equities since only about 0.7% of the market is traded daily (i.e., only 14,000 out of two million issues). These market realities result in high transaction costs. In fact, research shows municipal bond trades are significantly more expensive than equity trades of equal size.[12]

Municipal bond funds have better access to multiple dealers than most individual investors and have the capacity for large-volume trades, which renders a cost advantage over smaller investors, particularly when trying to achieve higher name counts to increase diversification. Funds offer better liquidity and broader diversification across issue type, maturity, credit quality, and geography, although shareholders do not control the selection of bonds in the portfolio. They also can access daily security prices and know the average credit rating within the portfolio. Equally important, managers should monitor average yields at different maturities, qualities, and regions to gauge the relative riskiness of different issues.

Fixed income securities are subject to increased loss of principal during periods of rising interest rates. Fixed income investments are subject to various other risks, including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications, and other factors. Municipal securities are subject to the risks of adverse economic and regulatory changes in their issuing states.
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End Notes:

1. Shawn Tully, “Meredith Whitney’s new target: The states,” CNNMoney.com, Sept. 28, 2010.

2. Dan Seymour, “Default Uneasiness Chases Investors from Muni Funds,” *American Banker*, Jan. 25, 2011.

3. Jane J. Kim, Eleanor Liaise, and Ben Levisohn, “Munis: What to Do Now,” *Wall Street Journal*, Jan. 15, 2011. Other factors that possibly contributed to the selling pressure are: (1) a major Treasury selloff in late 2010, (2) Standard & Poor’s downgrade of “tobacco bonds” to junk status, (3) expiration of the Build America Bonds program in 2010, and (4) extension of the Bush-era tax cuts.

4. Mary Williams Walsh, “A Path Is Sought for States to Escape Their Debt Burdens,” *New York Times*, Jan. 20, 2011. Bankruptcy would enable a state to alter its public pension liabilities and treat general obligation bond holders as unsecured creditors.

5. Randall Forsyth, “The Sky Isn’t Falling on the Muni Market,” Barrons.com, January 7, 2011.

6. Iris J. Lav and Elizabeth McNichol, “Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm,” Center on Budget and Policy Priorities, Jan. 20, 2011.

7. Robert Novy-Marx and Joshua Rauh, “Public Pension Promises: How Big Are They and What Are They Worth?” *Journal of Finance* (forthcoming).

8. Agnes T. Crane, “States’ Troubles Are Not the Real Risk for Muni Bonds,” *New York Times*, Jan. 30, 2011. Also see Randall W. Forsyth, “Man Bites Dog in the Muni Market,” Barrons.com, Feb. 1, 2011.

9. Andrew Ackerman. “SEC Could Gain Authority to Regulate Muni Disclosure,” *Wall Street Journal*, April 13, 2011. The SEC indirectly regulates municipal market disclosures through the banks and broker/dealers that underwrite municipal securities. Under current SEC rules, dealers cannot underwrite municipal bonds unless the issuer has agreed to provide annual audited financial reports and to notify the market of certain events, such as a change in credit rating.

10. Bank of America Merrill Lynch 1-10 Years AAA-BBB US Municipal Bond Index.

11. Municipal Securities Rulemaking Board (MRSB) 2010 Fact Book.

12. Lawrence E. Harris and Michael S. Piwowar, “Secondary Trading Costs in the Municipal Bond Market,” *Journal of Finance*, 61, no. 3 (June 2006): 1361–1397.