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Munis: Good Bet After All

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Municipal bonds remain a good investment, despite previous predictions of disaster. Defaults are few. State governments are reining in unsustainable pension obligations. Bond insurers avoid issuers that don't honor their debt, and recommend investors do that, too. One big risk: mutual funds and exchange-traded funds.

Muni bonds defied star analyst Meredith Whitney's dire prediction [1] in 2010 on *60 Minutes* that warned of "hundreds of billions of dollars" of municipal defaults within the following 12 months. That did not materialize, but many worried investors likely fled municipal bond funds as a result of her prediction. Since 2010, there have been a few very prominently publicized defaults, raising the question of whether her prediction was simply early.

Municipal defaults recorded lately mirror the historical levels and are in no way extraordinary – a tiny fraction of 1% of bonds rated by the rating agency Moody's [2]. The rating agencies define a default as a failure to pay bondholders interest and principal in cash, as promised, when due. Some newsletter writers count "technical defaults," which are when an issuer dips into its reserve fund to pay investors. This action may signal it is more likely to default, but the issuer may not actually. Meanwhile, bondholders have not suffered any losses.

There are powerful incentives to keep an issuer from defaulting. The most important is maintaining access to the capital markets. The bond market participants do not forget which municipalities defaulted in the past. In addition, most municipal debt is structured to pay for projects over time, and is only a small part of the overall budget.

Defaults tend to be by small issuers, often for special purposes uses. In the once-booming housing markets of Florida and California, for instance, a number of "dirt bonds" are in default. These are from community development districts where homebuilders used the bond-issue proceeds to build roads and utilities for failed new housing developments.

With the largest muni defaults, bondholders eventually got all their money back: New York City (1975); the Washington Public Power Supply System (1983), nicknamed WHOOPS; and California's Orange County (1995). New York's spending got out of control, WHOOPS built unneeded nuclear plants it abandoned and Orange County bet incorrectly on the direction of interest rates.

Today, the biggest threats to munis are from very generous public pensions that far surpass those of the private sector. When the projected revenues did not appear, the governments chose not to fund the pension obligations. By kicking the can down the road, the obligations became the problem of the future officeholders. They sometimes borrowed money through the bond market to contribute to the pension funds, thinking that stock returns would be higher than their borrowing costs. Then came the financial meltdown in 2008. Based on current trajectories, the pension funds will run out of money and be unable to meet their obligations.

With the exception of Vermont, the constitutions of all the states forbid the state government to declare bankruptcy and repudiate its debt. However, each state has its own laws concerning bankruptcy for local governments. For example, Rhode Island has passed a law forbidding its cities and counties from declaring bankruptcy, while other states try to control local municipal access to bankruptcy procedures.

Vallejo, in California, was one of the first cities to opt for bankruptcy in the last few years. Enormous pension obligations burdened Vallejo, which filed for bankruptcy in 2008. Under California law, the city could not modify its pension obligations. After emerging from a three-year bankruptcy, the city has a workforce that is 50% smaller. But the same pension obligations still weigh on it, an unsatisfactory outcome to most of the stakeholders.

Elsewhere, though, governments are moving to get a handle on this problem. Rhode Island [3] recently passed legislation creating a hybrid plan that merges conventional public defined-benefit pension plans with 401(k)-style plans that affects both new and current employees. The state raised the retirement age and suspended cost of living adjustments. This law will be challenged in the courts, but it is a precedent-setting action.

Municipal bond insurance got a bad rap from well-known insurers' losses and subsequent bankruptcies. Those failures had nothing to do with munis, but from covering mortgaged-backed collateral debt obligations, slammed in the financial crisis. Though municipal bond insurance still backs some issues, its prevalence is much reduced—5% of all new issues, down from 50% pre-crisis.

If you own an insured bond that defaults, you will be glad that you have insurance. Assured Guaranty Ltd. backs the Jefferson County (Alabama) general obligation warrants that went into default in November 2011.They are also on the hook for the Harrisburg defaulted incinerator debt, despite the Pennsylvania city's guarantee to pay it. In Harrisburg, city council members rejected a fiscal recovery plan. Those settlements are yet to be worked out.

There is a new insurance company that hopes to start operation next month with AA ratings. It is called Build America Mutual Assurance Co., a mutual insurance company that will be 100% owned by municipalities. It will seek to rate investment grade bonds in the BBB and A ranges.

Bond insurance companies have political and economic clout that comes from ceasing to insure issuers that seek bankruptcy protection. Follow their lead and avoid the bonds of states that are not responsive to the needs of municipal bond investors. Also, remember that bond insurance doesn't make a bad bond good—the insurance is only as good as the solvency of the insurance company.

Amid the chatter about municipal bankruptcy, a less visible possible threat is the rising price of the bond funds. With interest rates at historic lows, Reuters [4] reports that in in early May, $8.55 billion flooded into bond funds, "the most in over a decade." Investors flee stocks for the perceived safety of bonds.

However, bond funds and exchange-traded funds (ETFs) are quasi-stock investments. Unlike individual bonds, they never come due or pay back their face value. You can lose a great deal of money when rates rise. Competing with one another for investors' dollars, funds often buy the highest-yielding bonds, adding risk to the portfolio.

For an in-depth discussion of the risks of bond funds, you might read our article "Buy Bonds and Not Bond Funds" at our website [5]. While there might be a certain amount of safety in numbers, the default of even one bond in a fund can seriously eat into your overall return.

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