Should You reach for Yield?

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Many bond investors believe that their due diligence is done even if their research consists of just buying the highest yielding bonds. We suggest that more inquiry is required. A main reason to buy bonds is to keep your principal safe.

The purpose of this article is to encourage you to identify and consider the potential risks before buying a bond fund, ETF or an individual bond. We will proceed by describing some of our experiences around the concept of risk. Please consider the following stories and vignettes. This article is more like a mosaic to caution you and encourage you to look more deeply before you decide to make an investment. We suggest that investors should spend more time picking out a bond, than picking out a shirt.

WHAT DOES IT YIELD?

The usual question people ask when considering an investment in bonds is: What does it yield? If they are going to pick a fund or an ETF, they might go to Morningstar, see the layout and pick the one yielding the most. This may be misleading because traditional Morningstar ratings reflect the past, not future performance.[i]

Before becoming a bond maven, Stan went to Columbia Law School. When he received his first term's grades, which were based solely on the final exam, he was confused. He thought he got another student's test scores. On the tests that he thought were not difficult, he received a lower grade. On the tests that he found very difficult, he received a high grade. So, he marched down to see the Dean. The Dean smiled and cleared up the confusion quickly. He said that if Stan found the test easy, he missed most of the issues that were buried in the fact pattern. The Dean continued that there were no easy tests - and suggested that Stan study harder next time!

Picking an investment that yields the most means that you may not have studied enough to see the issues. Here is a better question for you to consider: Why is this investment yielding so much more than similar investments?

WHY IS A FUND MANAGER'S PERSPECTIVE DIFFERENT FROM FUND INVESTORS'?

The managers' concern looks like this: How can I attract more investors to my fund? If I don't, I will soon be dismissed. I must offer more yield. But how can I do that? There are a number of strategies he might use:

- Pack the fund or ETF with lower grade bonds with longer maturities to the extent the fund charter will allow. They will probably be found under the title 'miscellaneous.' Hope there is no liquidity crunch.
- Take lower fees a la Vanguard or Fidelity, but the fund company may not approve.
- Execute better and fewer trades to reduce trading costs, and hope for the best.
- Leverage the portfolio, use options and derivatives if allowed to magnify gains. Again, hope for the best.
- Hold less cash if money market rates are low, so more of the assets can be reinvested. This might result in more liquidity risk.

<u>A Case Study – Puerto Rico Bonds</u>

Here is powerful example of a strategy followed by many bond funds and ETFs. Many bond funds and ETFs purchased bonds issued by Puerto Rico. This was a common strategy followed by the many muni tax-exempt single state funds. There was a big demand for Puerto Rico bonds for two reasons:

- Bonds issued by the U.S. Territories are triple-tax exempt in all U.S. states and therefore could be held by single state funds without any adverse tax consequences.
- The yields were juicy compared to in-state issued bonds due to ample supply, and the ratings were investment grade.

When Puerto Rico defaulted, the Territory had issued $73 billion in debt (this is not a typo) with a population of 3.2 million in 2018. To put this in perspective, Puerto Rico was the third largest issuer of municipal debt after California and New York! To make investing in Puerto Rico more complex, not all of the debt was general obligation debt. It was sliced and diced into the debt of different agencies and authorities.

One question never asked is – Where did all that money go? Now the Puerto Rican government wants to claw back interest payment for some of their general obligation bonds they say were illegally issued because it exceeded the debt limit for the territory. However, if the bond issues are invalidated, the Puerto Rican government might be required to return principal. Reading about Puerto Rico helps to make clear just how mismanagement can go on for years, until there is only one option left – default.

WHY NOT BUY THAT HIGHER YIELDING INVESTMENT?

Lower rated bonds may have a higher yield-to-call and a higher yield-to-maturity. You may think to yourself: Mmmm, munis have a low default rate. Why not buy that higher yielding bond and get the better return? Or better yet, this preferred stock yields even more. Why not go for the yield?

Low rated issuers keep issuing debt to keep the entities alive. Eventually events may happen that dry up funding sources. They keep paying interest or dividends if they are a corporation, until they are out of options. Do you remember playing the game musical chairs? The game continues until there is only one chair left. You may not be the one sitting in it.

Munis have a good payment history, but corporate bonds not so much, as reported in The Wall Street Journal.[ii] Moody's Corp's review of its data states that the default rate on muni bonds has been about 0.1% since 1970. However, for unrated non-investment grade ratings, the default level is higher. Corporate default rates are reported at 6.7%. In default currently are about 2.5% of unrated muni bonds, according to Municipal Market Analytics.

The past may not foretell the future if the future is different than the past. For example, about half of corporate bonds are now rated BBB, which is one notch above junk bonds. If there is a recession, there will be many downgrades. Many funds and ETFs can't hold junk bonds and will have to sell them. The large investment banks are no longer big players supplying liquidity to this market. This may not end well.

WHY DOES A BOND DEFAULT?

A bond defaults because the sources of revenue that were supposed to fund the bonds are inadequate. General obligation bonds are funded by ad valorem taxes (based on real estate) and many other sources of revenue. That means that in the event the housing base is damaged, there may be revenue problems. Revenue bonds are backed by only specific sources of revenue.

Bonds default for a number of reasons but they can be summed up this way. Financial projections were not actualized and/or there is an unwillingness to pay the debt. When money is tight, the issuer, and perhaps the court, must decide how to allocate funds among competing creditors.

Munis fund difficult projects. For example, The Wall Street Journal[iii] published a long article on the refurbishment of I-4, the interstate road in Orlando Florida. It exemplifies the problems associated with reconstructing 50-year old infrastructure. This major highway is embedded within a busy metropolis that hugs the interstate, magnifying problems that could more easily be dealt with in less congested areas. The road has to stay open. The public-private partnership has to work. The contractors have to coordinate with utilities to find and move gas pipes, sewer lines, water mains, storm drains, electrical wires and fiber-optic cables. Limestone footings make sink holes a possibility. With some latitude, the endeavor has to work for the bond holders to be paid. If problems are insurmountable in a timely manner, the bonds may be downgraded. Large projects with state oversight are more likely to overcome difficulties encountered.

There is usually some warning that an issuer is experiencing difficulty meeting its obligations. All municipal issuers are required to post information about material events that might affect the ability to repay the bondholders for the life of the bond.

HOW DOES A BOND GET TO BE NON-RATED?

Newly issued bonds can start out non-rated, if the issuer sees that the rating will not add to the salability of the bonds. The other way they can get to be non-rated is if the rating agency chooses to remove its rating. As the credit conditions of the area deteriorate, the rating may be reduced to a lesser quality, or simply terminated.

Unlike love, once given, ratings are not forever. If economic conditions change, the ratings may change. If there is a radical deterioration that threatens the repayment of the bonds then the bond rating can drop multiple categories at one time. This does not happen often, but it can happen.

For example, Better Housing Foundation, established in 2015, sold $84.4 million of bonds to purchase affordable housing projects in Chicago.[iv] At issuance, the debt was rated triple-B for the subordinated debt and single-A for the senior debt. The offering statement suggested a significant degree of risk of non-repayment. By 2019, three of the five properties were in danger of default. The rating agency requested information, which if not forthcoming in 30 days would result in the rating being withdrawn. These were investment grade bonds when first issued, but quickly deteriorated to junk bond ratings. Losses can come from downgrades, as well as defaults.

How do you decide what quality bonds you are going to buy? If you purchase bonds that yield the most, then you might purchase non-rated bonds and non-investment grade bonds. Those are bonds rated double-B or lower. If you focus in on buying bonds that yield the most, you may be unaware that other investors also saw that as a good deal – the media is always advertising the benefits of high yield, A.K.A junk bonds. For example, The Wall Street Journal gave performance ratings for high yield muni bonds at 5.5% in 2019 including interest payments, and corporates performed at 8.8% according to FactSet data.[v] This might motivate you to invest in this sector. However, it is only when there is a default that the market wakes up and investors decide to exit, akin to all the elephants trying to get through the door at the same time. Once there is blood in the water the sharks appear, bids disappear, and sales prices drop. This is nicely called a liquidity event. This means that you can't sell the bonds for a fair price and sometimes there may be no buyers at all. Funds have limits on the amount of lower grade bonds they can hold, and will jettison loans with lower B ratings when they expect they might go to triple-C.

DOES PURPOSE FOR BOND ISSUANCE MATTER?

While the purpose for bond issuance, per se, does not matter, it is often indicative of the security behind the bond issue. For example, issues that are voted on and approved by the voters are more likely to have the support of the population and therefore more likely to be successfully repaid. Muni bonds especially, are supposed to fund projects that produce some overall benefits for the community. The more you stray from broader community benefits, the riskier the projects become. For a community to function, you need good schools, water, electricity, and housing. Projects which do not have community support entail more risk. Ideally, bonds are supposed to be issued to create a greater good that will create better living conditions or infrastructure to improve commerce.

Pension obligation bonds are a case in point. When pension funds issue bonds, their strategy is to borrow at a fixed low cost and then invest the funds in higher yielding investments. The underlying assumption is that if you invest in the stock market, private equity or real estate then the return on the investment will be higher than the costs of the bonds. Unfortunately, this happy result may not happen. Sometimes instead of earning more the risk investment may just lose money.

Some investors in State of Illinois bonds have brought suit against the state saying that $11 billion of bonds were issued illegally. According to *The Bond Buyer*, "Illinois Policy Institute head John Tillman, acting as a taxpayer, and Warlander Asset Management LP, which hold $25 million of Illinois debt filed the taxpayer/bondholder litigation" on July 1, 2019.[vi] The bonds were issued in 2003 and 2017 to fund the pension plans and to pay down debts. According to the suit, this amounts to deficit spending and is not a qualifying "specific purpose" which is allowed by the Illinois constitution. Though the suit was dismissed by the lower court, the ruling will be appealed.

Some pension managers and legislators believe that the pension fund's borrowing in the bond market may just be paid out to the pensioners without regard as to how to repay the bond holders. This is part of the new think mentality that the chickens never come home to roost.

We rely on the rating agencies to give us an insight and an initial judgement into the purported quality of a bond. However, you have to consider for yourself if you agree with their judgement. Ask yourself, if it were issued in your jurisdiction, would you be willing to support the bond obligation? If your answer is no, then the likelihood of other borrowers supporting it is much less likely.

CONCLUSION

Though you may be a bottom fisher who has successfully reaped higher returns in the past, all you need is one bond default to put you in the red and set back years of higher interest payments. If you play in Wall Street's game, you may buy and sell distressed securities until the asset bubble explodes and you are left trying to pick up the pieces. If what you are considering buying is yielding so much more than another issue, we suggest that you find out why.

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[i] Morningstar, " Morningstar to Enhance Forward Looking Fund Ratings," July 8, 2019. Morningstar plans to institute forward looking ratings beginning on October 31, 2019 to reflect the impact of fund fee differences on fund performance. https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2019/Morningstar-to-Enhance-Forward-Looking-Fund-Ratings/default.aspx

[ii] Gunjan Banerji. "Risky Municipal Bonds Keep up a Hot Streak." *The Wall Street Journal,* May 28,2019, pp. 1-2.
[iii] Arain Campo-Flores and Paul Overberg. "The Interstate is Crumbling. Try Fixing it in Roaring Traffic." The Wall Street Journal. pp A1 and A8.
[iv] Yvette Shields. "Bonds for Chicago Affordable Housing portfolio near default." *The Bond Buyer.* May 20,2019.
v Banerji. May 28, 2019.
[vi] Yvette Shields. "Muni analysts unfazed by legal challenge to Illinois bonds" *The Bond Buyer.* July 5, 2019