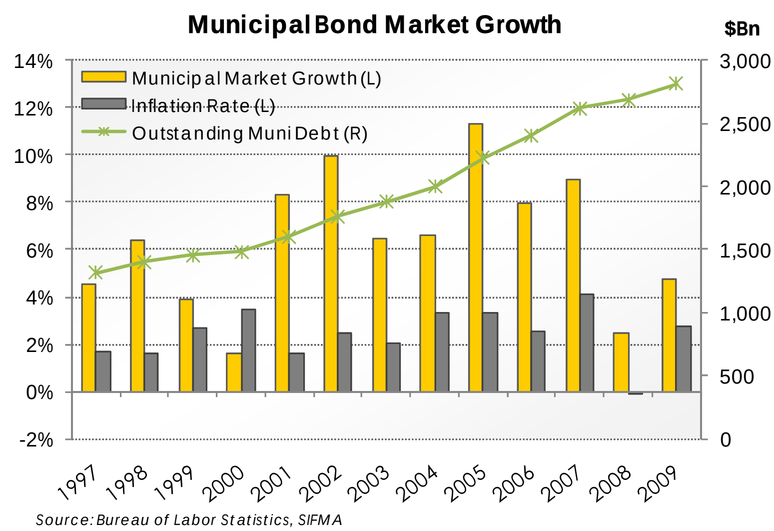
# Fact Versus Fiction: The Truth About Muni Bonds

Municipal bonds are not supposed to make investors nervous. In fact, they are supposed to conjure up images of safety, income and tax relief. Right now none of those characteristics seem like a sure thing. Every day we see headlines comparing our states' budget problems with those of Greece and Spain, touting the risk of default. We are grappling with basement-level yields and the meager income they provide, as well as the prospect of higher interest rates on the horizon. We are even dealing with a smaller supply of tax-exempt bonds as federally-taxable Build America Bonds fill much of the issuance calendar. The good news is that some of these worries are exaggerated. This month we discuss why the risk of default, even in California, is still exceptionally low, and how we are managing our clients' bond portfolios in this low-interest rate environment.

### *The Municipal Market is on the Brink of Disaster: False*

The municipal bond market has about $2.8 trillion in debt outstanding, issued by more than 60,000 state and local governments, districts, and authorities[1]. The size of the market has increased steadily over the last decade, with total assets growing faster than the rate of inflation in every year but 2000.




As many states approach their fiscal year-ends on June 30th, the stories of budget impasses and potential debt defaults are becoming more and more inflammatory. In reality, only 0.2% of current debt outstanding is in default – exactly in line with the 20-year average. Half of the debt in default was issued by a single county in Alabama. Clearly these statistics do not make for a systematic catastrophe, but many argue that the worst is yet to come. State and local fiscal situations could deteriorate further, but we disagree that a municipal default debacle is upon us. Unlike a corporation, states are unable to declare bankruptcy, forcing them to balance their budgets by raising taxes or slashing spending. Cities *can* file for Chapter 9 bankruptcy, but cities do not get liquidated as would a company. Cities continue to exist, and therefore must find a way to pay their debts in order borrow in the future. Even in the worst case scenario, it is extremely rare that municipal bond investors fail to get paid at all.

[1] Municipal Securities Rulemaking Board, Securities Industry and Financial Market Association (SIFMA)

The bankruptcy of Orange County, the largest in U.S. municipal history, was a perfect example. After losing $1.6 billion on a derivatives bet, the county filed Chapter 9 bankruptcy in 1994. After two years of drastic cuts, the county issued long-term recovery bonds and paid back its bondholders at 100 cents on the dollar. Even during the Great Depression investor losses from defaults were very low. As we noted in our December 2008 publication, *"Fixed Income Mechanics,"* between 1929 and 1937, all but 0.5% of overdue payments on defaulted debt eventually were paid[2].

### *General Obligation Bonds Rarely Default: True*

A recent study by Moody's Investors Services found that between 1970 and 2009, overall default rates by U.S. municipal issuers totaled just 0.06%[3]. This translates into a total of 54 bonds over a nearly-forty-year period. Typically, the bonds that defaulted were not general obligation (GO) bonds, which are backed by the taxing power of the issuing entity. Defaults were almost always the more business-sensitive revenue bonds, which are attached to a particular project's revenue stream. In the Moody's study, **three-quarters** of the defaulted bonds were revenue bonds related to healthcare or housing finance projects. The table to the left shows the stark contrast in defaults between GO and non-GO munis, as well as corporate bonds.

**10-Year Average Cumulative Default Rates, 1970-2009**

| Rating | General Obligation Munis | Non General Obligation Munis | Corporates |
|---|---|---|---|
| Aaa | 0.00% | 0.00% | 0.50% |
| Aa | 0.02% | 0.05% | 0.54% |
| A | 0.00% | 0.07% | 2.05% |
| Baa | 0.00% | 0.39% | 4.85% |
| Ba | 0.01% | 5.10% | 19.96% |
| B | 0.00% | 13.78% | 44.38% |
| CaaC | 0.00% | 14.07% | 71.38% |
| *Investment Grade* | 0.01% | 0.13% | 2.50% |
| *All Rated* | 0.01% | 0.19% | 11.06% |

*Source: Moody's Investors Service, "U.S. Municipal Bond Defaults and Recoveries, 1970-2009"*

### *California = Greece: False*

Since many of our clients are California residents, the state's budget woes illicit more than just a headshake while reading the newspaper. Despite how bad the state's fiscal situation appears, California is not Greece. We still are confident that investors holding high quality GO bonds from the country's largest municipal borrower have little risk of default.

The California economy produces $1.85 trillion annually, and is the largest state economy within the U.S. In fact, on a stand-alone basis it would be the eighth-largest economy in the world. By comparison, Greece's total GDP is only $342 billion,

| Gross Domestic/State Product ($Bns) | |
|---|---|
| U.S. | $14,430 |
| Germany | $3,273 |
| U.K. | $2,224 |
| ***California*** | ***$1,846*** |
| Spain | $1,466 |
| Greece | $342 |
| Ireland | $229 |
| Portugal | $222 |

*Source: BEA.gov*
*CIA World Factbook*

[2] George Hempel, *The Postwar Quality of State and Local Debt*, National Bureau of Economic Research, 1971
[3] Moody's Investors Services, "U.S. Municipal Bond Defaults and Recoveries, 1970-2009," February 2010

while Ireland and Portugal are even smaller than Greece. As a percentage of GDP, the state's budget deficit also compares favorably. According to Tom Dresslar, a spokesman for California's state treasurer, *"Greece's budget deficit in 2009 was 13.6% of its GDP. Our budget deficit, at $20 billion, was 1.1% of our GDP."*

California revenues for the upcoming fiscal year are slated to be just over $91 billion, an increase from the previous two year's revenues of $87 billion and $83 billion, respectively[4]. The first budget priority in California is education. A state constitutional amendment guarantees a minimum amount of funding for K-14 education, which in the current budget proposal accounts for about 45% of total revenues. Once this education funding requirement is met, however, the constitution requires the state to service its general obligation debt (both principal and interest payments). Default is just not an option for the state. In the current proposed budget, debt servicing accounts for just about 5% of revenues.

### *Build America Bonds Have Boosted the Muni Market: True*

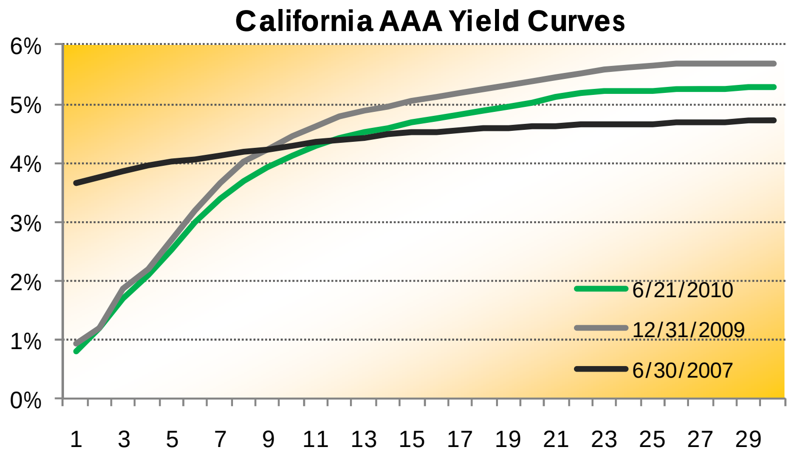
The municipal bond market received an unexpected boost from one of the federal government's stimulus programs. The Build America Bond (BAB) program was launched in April 2009 as part of the economic recovery act to help municipalities raise revenues. Municipalities are able to issue taxable bonds and receive a subsidy of 35% of the interest cost from the federal government, which reduces their debt servicing costs. The program has drawn more investors into the muni market with the higher yields offered by BAB's. A side effect of the attractiveness of issuing BABs is that municipalities have issued less tax-exempt bonds. With investors already desperate for high-quality muni bonds, the reduced supply is keeping prices elevated for investment grade tax-exempt bonds. Most investors, it seems, are willing to sacrifice yield for the safety of credit quality. Although originally slated to end in 2010, the BAB program has been extended, with a reduced subsidy schedule, through 2012.

### *All Municipal Bonds are Created Equal: False*

Municipal bonds are trading based primarily on credit quality, similar to corporate bonds. Although dipping into lower-rated bonds can provide additional yield, we are sticking to high-quality general obligation and essential services bonds despite their relatively high prices. One of the most important qualities that fixed income brings to our portfolios is safety. For that reason we must put credit quality and low default risk ahead of yield on our list of priorities. Although we believe the risk of broad-based defaults in the municipal market is low, isolated dislocations in the market are possible, and therefore we will maintain a high-quality portfolio of bonds.

[4] California budget information can be found at http://www.ebudget.ca.gov/

Yields at the short end of the curve are exceptionally low. Investors are putting a significant premium on liquidity right now in anticipation of higher interest rates. As shown in the graph at right, an investor must go out 7-9 years on the yield curve to obtain pre-financial crisis yields.



Source: Thompson Reuters MMD

Yields are down and taxes are heading up, but this is not necessarily bad news for muni bond investors. Expected tax increases should provide a tailwind for municipal bond demand over the next several years. The Bush tax cuts are due to expire at the end of this year, and the health insurance reform law will impose Medicare taxes on investment income[5], **with the exception of previously tax-exempt income such as that from municipal bonds**. This should make muni bond income even more attractive on a tax-equivalent basis.

***Muni Bonds Still Make Sense for Taxable Investors: <u>True</u>***

There are many things in the financial markets that cost investors hours of lost sleep, but municipal bonds should not be one of them. The risk of default in high-quality general obligations bonds is low, even in California. The state will pay its debt obligations. Low yields are definitely a challenge for income-seeking investors, but we believe that going too far out on the maturity spectrum is not warranted at this point in the interest rate cycle. We view a laddered portfolio of short-to-medium term, high-quality bonds as the best balance of yield and duration.

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[5] Beginning in 2013

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