INVESTMENT PLANNING

Municipal Bonds: An Unusual Investment Opportunity

By S Timothy Kochis

Sadly, there is not much good news these days for users of municipal services or for taxpayers, but municipal bond *investors* probably have little to fear. In fact, there may now be some unusually attractive investment opportunities.

With special thanks to my colleagues in Aspiriant's Investment Strategy and Research Department, led by Aspiriant's Chief Investment Officer, Jason Thomas, PhD, here are some of our current thoughts on the attractiveness of municipal securities in the current market environment.

The Great Recession has created a financial strain on state and local municipal bond issuers, with a few commentators predicting huge losses for municipal bond investors. We don't think so. Let's consider the challenges facing issuers of municipal bonds, the safeguards for investors, and scenarios in the case of default and implications for client portfolios.

Overview of the Municipal Bond Markets

Less than one third of municipal bonds outstanding are the direct debt of state and local governments, and about nine percent of that is "prerefunded" (collateralized by US government bonds).[i] Most of the remainder is revenue bonds, half of which are utilities with rate-setting powers and generally less impacted by recession.

The historical experience of municipal bonds is that they very rarely default. Both the number of instances and the dollar impact have been small. According to the most recent studies from Moody's and Fitch, two municipal bond rating agencies, the 10-year cumulative default rates for all municipals, including high yield, are 0.09 percent and 0.58 percent respectively. The vast majority of issuers (perhaps over 80 percent) in the municipal market that have defaulted did not have taxing authority.

Even during the Great Depression, most defaults did not last long (interest payments were missed, but payments were resumed shortly and any deficiency cured) and the estimated loss on the total was only about 0.5 percent.[ii]

There are two principal challenges facing municipal bond issuers:

1. Substantially reduced tax income; and
2. The growing burden of pension and retiree health care obligations, most of which are unfunded.

A number of states entered the recent crisis with existing budget gaps and underfunded pensions already on the books. The accumulation of further annual deficits is too large to be solved by a few years of good economic growth. The budget gaps of California, Illinois, New York, and Texas for FY 2012 account for 50 percent of the total.[iii]

Still, contrary to common perception, there has not been an increase in defaults. Standard & Poor's reports that, through late 2010, municipal bonds defaulted at roughly the same pace as in 2009—a mere 0.3 percent. A significant increase in municipal defaults seems unlikely.[iv]

Low current cost of debt service

The primary reason is that the cost of servicing debt is now very low, with interest payments

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representing a relatively small part of state and local budgets. With the very long average maturity of municipal bond borrowing, municipal bond refinancing risk is quite small relative to corporate borrowers.

Opportunities for revenue enhancement

Even without tax rate increases, municipal finances will improve as the economy recovers. According to the State Controller's Office, California's general fund revenues for 2010 through September were $1.2 billion (6.7 percent) higher than expected.

If the recovery proceeds too slowly, state and local governments can raise rates, exploiting their captive tax bases. For example, many cities are raising property taxes by double digit percentages.[v]

Opportunities for expense reduction

State and local governments have demonstrated willingness to maintain budget balance while making full and timely debt service payments. The National Association of State Budget Officers reported that 43 states cut their budgets in 2009 and 42 did so again in 2010.

Prioritization and protection

Moreover, officials managing municipal finances cannot arbitrarily choose to pay other expenses instead of debt service. The priority of payment is generally very high, so that a bondholder is well positioned, even in financial stress.[vi]

Security for general obligation (GO) and dedicated tax bonds is very strong, provided for in state constitutions, statutes, covenants with bondholders, and local ordinances. In California, only education spending has a higher priority than debt service; in New York and Illinois nothing does.

Pension obligations—a light at the end of the tunnel

Most of the actual pension expenditures will not be made for many years, giving pension plan sponsors time to make necessary adjustments. According to the U.S. Census, in 2008 public pension assets totaled $3.2 trillion as compared to "only" $175 billion in annual payments to retirees. Improved investment markets will naturally increase the funded status.

States are also taking steps to reduce their long-term pension liabilities. According to the PEW Center on the States, in FY 2010, 19 states took action to reduce their pension liabilities. Illinois, for example, raised its retirement age for new employees from 60 to 67.

These protections for municipal bond investors are reflected in the ratings on municipal bonds. In November 2010, Moody's Investors Service affirmed the A1 rating and stable outlook on California's outstanding general obligation bonds and credits whose ratings are linked to those of the state, despite the high profile hand-wringing of some economic pundits.

But what would happen in a worst case scenario, where a state or large municipality actually defaulted?

Bankruptcy

Before a municipal issuer defaulted on its debts, it would consider a number of restructuring options. Some municipal issuers have the option of a Chapter 9 bankruptcy filing, which may be the only way to restructure their obligations, particularly pension-related obligations.

The fundamental objective of Chapter 9 is to provide court protection for distressed municipalities, allowing them to adjust their debts in a manner which enables them to continue to provide essential public services.[vii] There were 10 municipal bankruptcy filings in 2009 and five in 2010. Since the law was created in the 1930s, there have been about 600 cases; or only about eight a year.

The recent bankruptcy filings appear to be aimed at restructuring pension obligations rather than debt.

Not all municipalities would be able use bankruptcy protection. Twenty one states do not allow municipal bankruptcy filings, partly out of concern for hurting bond investors.

Unlike local municipalities, states are barred from seeking protection in federal bankruptcy court. Right now, a number of politicians and academics are pushing to allow states some form of relief.[viii] To date, all of these proposals have focused on onerous pension obligations rather than reducing outstanding debt.

Default

If a municipal issuer did default on its debt payments, creditors would seek to recover their principal, just as they would with a corporate borrower. Bond offerings from many local governments explicitly grant creditors the right to specific tax revenue, which may put those creditors in a better position than other unsecured creditors. There is no modern experience with a state defaulting on its general obligation bonds. Several states defaulted during the Civil War, and Arkansas defaulted during the Great Depression, but these situations would likely not provide any current guidance.

Implications for investment portfolios

Current conditions for state and local governments are the most challenging since the Great Depression. In all likelihood the risk of further downgrades and defaults will remain elevated for several more years.

While that is true, it is important to understand that municipal bonds are still one of the safest investments. The default rate in 2010 was only 0.3 percent which is in-line with the long-term historical average and reveals that governments are largely managing through the downturn by making tough fiscal decisions.

In the long-run, we believe the Great Recession will be a positive for municipal investors, creating demands for greater transparency, and most importantly, forcing public officials to address runaway spending and unsustainable public sector obligations they otherwise would have little appetite for rectifying.

Additionally, we expect demand for municipal debt to remain high as investors continue to take advantage of a steep municipal yield curve and attractive credit spreads versus low-yielding treasuries and cash alternatives. By almost every measure, we see good relative value in today's municipal bond prices, compared both to their own historical levels and to other parts of the fixed income universe.

For investors under-allocated to municipal debt or holding higher levels of cash, we believe it is an opportune time to restore strategic weightings or reinvest excess cash. Although we are generally optimistic that the large majority of issuers will rise to today's challenges, there will certainly be areas of the market that are more vulnerable, so we recommend exposure that is both professionally managed and broadly diversified.

ENDNOTES

i See Payden & Rygel, "Fact vs. fiction in the muni market," December 28, 2010.

ii Hempel, George. The postwar quality of state and local debt. New York: Columbia University Press, 1971.

iii Barclays Capital "Taxable municipal market commentary," December 3, 2010.

iv See, e.g., November 16, 2010 report by Fitch "U.S. State and Local Government Bond Credit Quality: More Sparks than Fire."

v See "Pensions push taxes higher," December 24, 2010, *Wall Street Journal*.Illinois, for example, has not been paying bills for years and yet continues to make all debt payments.

vii House Report No. 95-595, 95th Cong., 1st Session 263 (1977), U.S. Code Cong. & Admin. News 1978, pp. 5787, 6221.

viii See "State bankruptcy option is sought, quietly," January 20, 2011, *New York Times*.