CFA Institute

EXCERPTS FROM A ROUNDTABLE DISCUSSION ON THE MUNICIPAL BOND MARKET

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UPDATE

On 10 June 2010, CFA Institute convened a panel of experts in municipal finance for a roundtable discussion. Excerpts from the conversation were published shortly thereafter, and the resulting article ended up being one of the most popular readings on our site. Given that so much has transpired in the muni world over the last six months, we asked our experts to provide a brief update to help our readers make sense of recent market developments. Following are their comments.

Paul Jungquist, CFA

Bonds with intermediate duration that provide regular cash flows (from sinking fund payments, for example) are valuable in the current environment for three reasons. First, given the historic steepness of today's yield curve, investing in the intermediate part of the curve will allow an investor to capture an extra 200–500 bps of yield over very short duration securities. Second, those sinking fund payments (early return of principal) can be reinvested at higher yields once interest rates start to rise, thus providing a hedge against inflation. Third, the obligation to make regular payments imposes a certain discipline on the issuer to manage its financial resources prudently to meet its financial obligations now, as opposed to "kicking the can down road" or delaying necessary budget cuts or revenue raising activities, which an issuer may be able to do if many of its bonds are zero coupon or bullet maturities. An investor can take comfort in knowing that the obligor of the bonds is keeping its financial house in order. Floating-rate bonds could also provide a very good hedge against inflation. If you are worried about inflation, the instinct is to be very short in duration. But the use of bonds with regular cash flows or floating rates can provide a hedge and produce more yield and total return in the meantime.

Steve Klein

Concerns about impending defaults have led to a dramatic weakening of municipal bond prices. Today, well-rated municipal, essential purpose credits are trading, on an absolute basis, at 100 bps over comparable-term U.S. Treasury bonds—more than 9 percent on a taxable-equivalent basis. Although the fiscal troubles of the state and local government sectors are real and well documented, the likelihood of significant municipal defaults is very low. Even in the current environment, debt ratios remain modest, and willingness to pay remains high. Furthermore, states are frequent issuers, and access to a liquid municipal market is critically important. Even the suggestion of a default could saddle an issuer with penalty pricing for years into the future at a cost far greater than any foregone payment.

The expiration of the Build America Bonds program also took the market by surprise and contributed further to weakness because of concerns about oversupply and the loss of what had been a very popular alternative to traditional tax-exempt bond issuance. As a consequence, the market will return to its pre-ARRA (American Recovery and Reinvestment Act of 2009) state, where the traditional market will shoulder the full weight of issuance needs. This development has led, and will continue to lead, to continued supply pressures and pricing weakness in the market. However, volume in 2011 has sunk to levels not seen in the past decade, easing these concerns and allowing some recovery in the tax-exempt market.

Regulation from the U.S. SEC and MSRB (Municipal Securities Rulemaking Board) on disclosure (a long-standing problem for market liquidity) and professional services (particularly financial advisers) has pushed market standards closer to those seen in the corporate market and further eroded the long-cherished, self-regulated status of the municipal market. Much remains to be accomplished in this area to make these initiatives effective across the diverse and diffuse marketplace, but the trend seems well under way.

Kurt van Kuller, CFA

Since the roundtable discussion in June 2010, the wave of negative media coverage regarding municipal credits has continued to mount. A lot of professionals in the municipal bond market have never witnessed such a barrage of bad press, but those of us "experienced enough" to remember the 1970s recall similar headlines, primarily resulting from the New York City financial crisis and widespread urban distress.

A confluence of events (credit fears, record supply, the abrupt termination of the Build America Bonds program, deferral of the scheduled rise in federal income tax rates and a correction in the Treasury market) led to a major market correction at the end of 2010. Heavy redemptions by tax-exempt mutual funds helped fuel the sell-off, suggesting that small investors collectively headed for the exits. Most institutional investors, however, did not augment the rush of sell orders, and many now see selective buying opportunities because municipals are quite cheap relative to Treasuries.

Most of the municipal bond market is far removed from the credits that have garnered the media attention. State and city general obligations account for less than half of all municipal bonds. One important note: Volatility has increased as a result of the demise of the bond insurance industry. The retail market in particular came to treat municipal bonds as commodities because of insurance wrapping, and it is now exposed to the vicissitudes of municipal credit risk for the first time since the early 1980s.

I think the challenge for investors will be to look past the highly visible distress narratives (like Harrisburg, Pennsylvania, and Jefferson County, Alabama) into the universe of over 20,000 rated credits. If they succeed, they'll find securities that will safely meet any given objective.

EXCERPTS FROM THE 10 JUNE 2010 DISCUSSION

Collimore: Let's begin with a description of what muni bonds are.

Klein: I divide the municipal market into two spaces: the monopolistic service providers (cities, towns, and authorities) on the public side, where the ability to raise rates or taxes is the ultimate security for the transaction, and structures, which by virtue of federal tax law or other convention get lumped into the muni market but bear much more of a resemblance to corporate securities—healthcare being the easy one to think about.

van Kuller: The municipal bond market is almost $3 trillion now. It's about as broad as the corporate bond market, if not more. There are many sectors of revenue bonds and project financings, including utilities, hospitals, higher education, transportation, housing, tobacco bonds, special assessments, and many more.

Collimore: Historically, municipal bond defaults have been lower than corporate default rates. I'm wondering if that trend is likely to continue in your view.

van Kuller: In my view, yes. Local governments do not disappear. They have far less event risk. Bankruptcies are extremely rare for municipalities. There's a study by George Hempel, in which he determined that about 3,000 municipal bonds defaulted throughout the entire Great Depression. They totaled about 15 percent of the outstanding debt, and the ultimate recovery was 99 percent.

Collimore: Paul, from the buy side, do you have any particular concerns about the credits out there?

Jungquist: General obligation issuers are facing greater challenges than they have in the past with respect to retiree pension and healthcare obligations. The ability to raise taxes still remains, but doing so is, I think, more difficult today than it has been in the past.

Collimore: I understand that ratings have been remapped at Moody's and Fitch. What does that mean for retail investors?

Jungquist: It's widened the "band" of credit quality within the various rating categories, so credit analysis is going to be more important than it has been. Also, ratings are generally higher than they have been, so reporting on a historical basis is going to be more difficult.

Collimore: What should investors think about bond insurance?

Jungquist: In terms of valuing bonds, the market treats the insurance as having no value. The legacy insurers still have considerable claims-paying ability, so I think in the short to intermediate term, that insurance is still valuable to investors, but if they're unable to write new business going forward, they're not going to generate revenues to pay many years down the line.

Klein: I think the industry is on life support. There is only one active financial guarantor in the marketplace, and its share of writings seems to be in a state of decline. The recalibration of municipal ratings changed the arbitrage that made bond insurance attractive, and some of the liquidity it historically provided is being found in other ways. The likelihood that any of the rating agencies will upgrade any entity in this space to levels where investors really care is remote.

Collimore: How do municipal bonds fit into a retail investor's portfolio?

Jungquist: Municipal bonds are one of the most important tax-advantaged strategies that an individual investor can use, but there's more to a place in the portfolio than simply a way to reduce one's tax liability. Historically, tax-exempt bonds have been far less volatile in price than virtually any other type of investment.

Collimore: How do you create diversification within a muni portfolio?

Jungquist: One of the best ways to do it is to invest in a tax-exempt mutual fund. Otherwise, you need to shop around, not only with the large Wall Street firms but also with regional firms to get a good mix of bonds. It does take some effort to get that kind of diversification.

Klein: I think the mutual fund approach is a better way to ensure diversification. The notion that an investor has the choice between buying bonds directly in an efficient way and investing in mutual funds is a bit of a false proposition. As a practical matter, that's not something a retail investor is likely to do, has any idea of how to do, or is motivated to do. The other issue that's at least worth mentioning is maturity-based diversification. It doesn't get at credit issues directly, but it does get at curve dynamics and other sorts of macroeconomic effects.

van Kuller: I think the science of credit analysis in munis is something best left to professionals. As we had mentioned at the outset, the municipal market has become much more complex, and there's really not a plain vanilla area for the majority of bonds. For the high-net-worth investor, there're some very reputable firms that offer managed accounts that provide the same type of expertise they use on mutual funds but tailored to the investor's specific needs.

Collimore: Is there a risk of unknowingly creating a portfolio concentration, credit or otherwise?

van Kuller: There is a strong tendency for investors in high-tax states to focus on bonds exempt from state and local income taxes, which pushes them into a concentrated position in state bonds. When you're buying in-state, you tend to get very concentrated in credits that are dependent on the state's credit. They may have different labels and appear different nominally, but are really linked to the same underlying credit.

Collimore: What if you're concerned about inflation?

Jungquist: What makes sense is to have a portfolio with regular cash flows: bonds with sinking fund payments or housing bonds that provide prepayments. That allows the investor to reinvest at higher rates as they come along. Floating-rate bonds would certainly also provide a very good hedge against inflation. The instinct is to be very short in duration if you're worried about inflation, but today, because short rates are so low, you're losing money by investing in the short to intermediate term.

Collimore: Are there any large looming credit risks out there that give you particular pause?

van Kuller: Some community development district bonds in Florida, known anecdotally as "dirt bonds," are under severe distress. It's estimated as much as $3 billion have defaulted, with another couple of billion more looming. This is a small niche of municipals.

Klein: And in all likelihood an entirely unrated niche.

van Kuller: Exactly, an unrated, high-yield area. I think that there's a great deal of negative press involving municipal credits. Some have compared it with what's happening in Europe, but there you're measuring debt and deficits against GDP. Here, we are measuring against the budget gap, and there's a tremendous difference in scale between those two measures. California has a gross state product of about $1.8 trillion and a general fund budget of a little over $80 billion. The gap for fiscal '11 is about $19 billion. That's pretty significant in an $82 billion budget, but compared to its GSP, it's a modest 1 percent. In Europe, you hear of deficits like 8 percent to 12 percent of their GDP.

Collimore: What about AMT?

van Kuller: Certain muni bonds can trigger additional tax liabilities because they are subject to the alternative minimum tax, but AMT bonds are easily avoided. They're less than 10 percent of outstanding bonds, and Congress has removed AMT from all new issues. But if you're certain you're not subject to the AMT, they can provide a nice yield pickup because they carry a higher coupon.

Collimore: What are Build America Bonds?

Klein: Build America Bonds are taxable bonds issued by states or other local issuers where a portion of the taxable interest is reimbursed to the issuer by the federal government. They drew a new class of investor into the tax-exempt bond market, which eased some of the supply pressure on the more traditional side of the market, resulting in relatively attractive rates over the term. As a feature of the stimulus bill, they are currently up to be renewed or extended. The terms of that extension are still subject to discussion and negotiation.

Collimore: What are some key facts you should share with your financial advisor before investing in muni bonds?

Jungquist: You need to share your risk tolerance with respect to both credit and price volatility; your tax situation currently; and what you expect it to be in the next few years.

Klein: Whether you intend to hold bonds to maturity or readjust your portfolio on an ongoing basis is a critical consideration. Are you planning to retire at the age of 55 or not until you're 70? What your need is for current income versus total return; I think those are all relevant to share.

van Kuller: An overlooked aspect of investing is the liquidity of the bonds. Before investing in some of the less-active issuers, carefully consider how liquid they are, particularly with regards to getting out at a price and spread similar to what you paid going in.

Collimore: How would you assess the liquidity of the muni bond market?

van Kuller: There's an enormous range, depending upon ratings, the obscurity of the credit, and the name of the issuer.

Klein: It's important to know that all muni bonds are serialized. Even though there may be a lot of a particular issue available in the market, if you're only interested in the 2017 maturity, that may be a much smaller universe. Another important distinction: the retail investor is talking, in market parlance, about buying odd lots, for which they're always going to pay a premium.

Jungquist: Even though your general method of investing may be to hold until maturity, things certainly come up, and you may need to sell bonds. I would emphasize that with your advisor and have them demonstrate how that execution would work.

THIS DISCUSSION HAS BEEN CONDENSED AND EDITED

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