



## Value in the Municipal Bond Market

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You can ignore the media hype that state issuers may default on municipal bond obligations and that these bonds are at risk of downgrades. “It is virtually impossible for a state to default on its municipal bond obligations,” says Tom Doe, founder and CEO of [Municipal Market Advisors](#).

Doe’s firm provides independent research and strategy consulting to a diverse client base of more than 200 dealers, investors, high net worth individuals and issuers engaged in the tax-exempt market. He is a frequent speaker at industry events and recently completed a three-year term on the Municipal Securities Rulemaking Board (MSRB), the municipal securities industry’s regulatory entity.

We spoke with Doe on February 9 at his firm’s Concord, MA offices.

General obligation (GO) bonds and essential service bonds (e.g., water and sewer) dominate the muni market, accounting for approximately 70% of issuance. According to Doe, these bonds are well-protected by tax revenue. “Politicians can raise taxes and fees to provide these services and service their debt — even though it would be politically unfavorable — and the taxpayers understand this,” says Doe.

Doe warns his clients to be highly skeptical of historical muni default statistics. “Any default study going back more than 20 years cannot be apples-to-apples,” explains Doe, because revenue bonds did not emerge until the 1970s. “You cannot extrapolate muni default rates from the Great Depression to today,” he said.

Investors seem to be hearing that message. Over the last eight weeks, demand for individual GO bonds has surged, and prices have risen. Since early December, yields on these bonds have generally dropped 100 basis points, from 4.30% to 3.30% with some specific high-quality GO state issues rallying 150 basis points.

“Investors should feel very comfortable with muni bonds, except for those rated below single-A or project-specific bonds backing shaky areas like health care,” Doe says. Health care is among those areas most vulnerable to the weak economy and susceptible to a reduction in aid, according to Doe.



Doe also recommends investors be wary of the high-yield muni market, even though it was the strongest performing municipal sector in 2009, up nearly 8%. Some of those funds, like Oppenheimer's Rochester National Muni Bond Fund, lost nearly half their value in 2008. Doe says Rochester is among those now reconstituting their portfolio with higher-quality names.

### **Three kinds of risk**

Although investors should not be concerned with default risk, two other dangers loom in the muni bond market: ratings risk and headline risk. The two are closely related, but in today's environment, Doe says, these factors combine to create more opportunity than risk.

"Headline and ratings risk are creating more volatility than ever before," says Doe. Prior to 2008, 60% of the muni bond market was insured, and downgrades were on the underlying insurer. Now, AAA-insurance does not exist, and ratings and price volatility have increased. Approximately 20% of this year's issuance has carried insurance. Whereas adverse headlines concerning a state's budget adversity (i.e. California) can reduce the trading value, evaluation and liquidity of bonds related to a specific event; ratings risk can depress the value of an individual holdings when a ratings service (S&P, Moody's or Fitch) reduces a credit rating of a bond (i.e. from A to A-). While the trading and evaluation value of a bond can be hurt by a ratings warning or downgrade, the change may have little to no relevance to the probability of default. Savvy and educated investors have historically taken advantage of credit risk to gain more value.

In addition, fewer banks and dealers are providing liquidity in the muni market, as there are fewer institutional buyers. Prior to the financial crisis, institutional demand came from hedge funds and from investment banks creating variable rate demand notes in order to satisfy investors seeking short-term, variable-rate bonds. Those sources of institutional demand, which depended on leverage, are gone.

Less price discovery means more volatility. And individuals are more sensitive than institutions to headline risk, further amplifying volatility.

"Since default risk is minimal, anything that lowers price is an opportunity for investors," says Doe, referring to the opportunities created by increased volatility.

A good example is bonds issued by the Massachusetts Water Authority. These were insured by Financial Security Assurance (FSA) and rated AAA, even though FSA was rated AA. Those bonds traded like AAA bonds through May of 2008, Doe said, but following the Lehman collapse, their prices dropped significantly. They rallied in November, but by the end of last year they were back to their



October levels, because FSA was downgraded (earning investors an additional 25 basis points of yield). Since then, they have rallied along with the rest of the muni bond market.

Another example occurred two weeks ago, when the New York Yankees baseball team sold bonds to finance their new stadium. Goldman Sachs underwrote the issue, which is to mature in 2049 and carries a 7% coupon. Within two days of issue, the bonds were trading to yield 6%, simply because they were undervalued. "Dealer firms have very little comfort managing their muni bond inventory risk," says Doe, creating an incentive to price deals attractively.

"None of the volatility in these two examples was related to the underlying credit of these bonds or the respective issuers," says Doe. "Once you take default off the table and understand this volatility, there are great opportunities to buy when the market weakens."

While default, headline, and ratings risk explain most of the volatility in the municipal market, long term investors face a fourth risk common to all fixed income markets – rising interest rates and inflation. No inflation-protected securities exist in the municipal markets comparable to TIPS in the Treasury markets.

### **Funds versus ETFs versus SMAs**

Doe cautions advisors to avoid mutual funds that are merely managed indices lacking aggressive management of their portfolios. Some fund companies have reduced staff and analysts, he says, making it more difficult for them to conduct comprehensive credit surveillance for the 65,000 issuers in the muni market. "Make sure you are getting the credit surveillance you are paying for," Doe says.

Separately managed accounts (SMAs) have grown aggressively relative to traditional muni mutual funds, according to Doe. "SMAs offer customization for the individual investor and are not necessarily managed to an index unless an investor prefers such a strategy," says Doe. These accounts can offer more diversification relative to coupon rates and strategic execution that takes advantage of specific credits, trends and value in the yield curve - managers pay more attention to individual securities. Lower minimums have made SMAs accessible for more accounts. "At the end of the day it may simply be that the managers are more accountable to the individual investor," observed Doe.

"Given the low default rate, you may not need the broad diversification offered by mutual funds," says Doe.



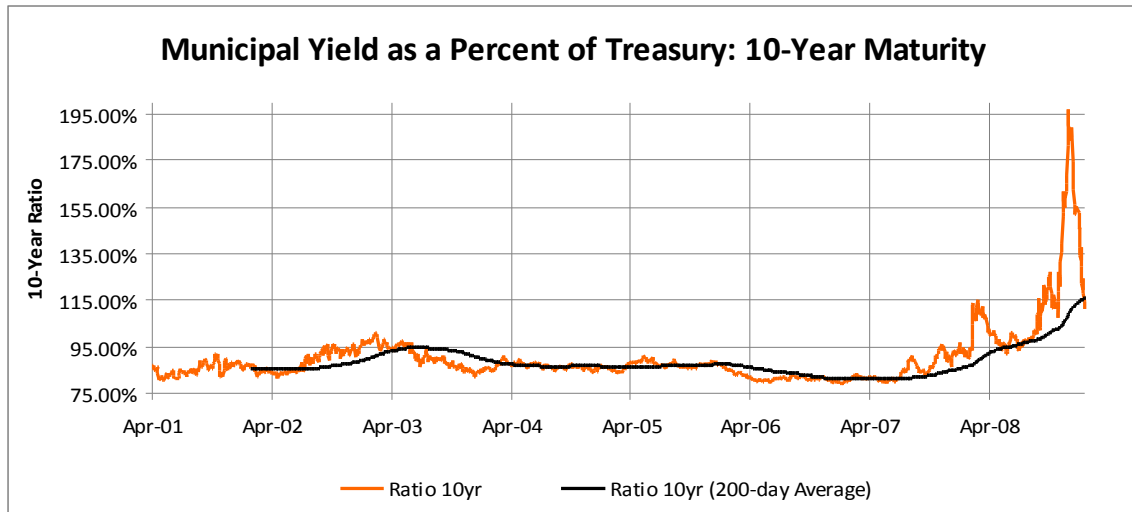
About 20 municipal bond Electronically Traded Funds (ETFs) are now available, and they are gathering assets, according to Doe. Some are focused on sections of the yield curve, on specific credit ratings, or on characteristics such as pre-refunded bonds. Doe cautions that liquidity issues can create large bid-ask spreads for these ETFs, but most are “hanging on” while other ETFs are closing down as their asset bases shrink. Municipal ETF’s are evolving. That they have managed to grow through the tumultuous events of the past 18 months is encouraging. They certainly pose a significant challenge to mutual funds that are also managing to an index, as the strategy is the comparable and fees can be lower and managed with greater tax-efficiency.

Pricing accuracy is a problem that plagues all muni products. Lack of liquidity means virtually all muni bonds are matrix-priced - the evaluation vendor calculates prices using theoretical spreads relative to similar-maturity municipal credits and Treasury issues. Most of the time, matrix evaluation works pretty well, but, occasionally, it fails completely. Such was the case in 2001, when Heartland Advisors saw one of its muni funds lose 70% of its value virtually overnight.

Matrix pricing is particularly problematic for ETFs, which must be priced on an intra-day basis.

### **Value persists in the market**

The flight to safety beginning in August, 2007 drove Treasury yields below those of comparable munis — a dislocation that has persisted since then to varying degrees. But, spreads relative to Treasury bonds have contracted recently. In December, munis were trading with yields 200% those of comparable 10-year Treasury bonds, and now that spread is a little bit over 100%. Historically, the average spread is 86-90% of Treasuries.



Source: MMA, Bloomberg

Spreads will eventually return to historical levels as yields on Treasury bonds increase and investors become less risk averse.

Doe is also concerned about a lack of supply in the muni bond market. At the end of the 1990s, muni bond issuance averaged approximately \$200 billion per year. This ballooned to \$400 billion a year prior to the onset of the credit crisis because of surging demand from hedge funds and institutions. Doe forecasts \$300 billion of issuance for 2009, but that may not be enough to satisfy demand from individual investors.

“It may be difficult for investors to get exactly what they want,” Doe says. But bond holders will benefit as the supply/demand imbalance drives up prices.

The level of support for states and municipalities in the stimulus bill is uncertain, and it is unclear whether TARP funds will be used to support the muni market. House Financial Services Committee Chairman Barney Frank, D-Mass, has suggested that the government should provide insurance to backstop municipal GO bonds.

“A lot is in flux,” says Doe. But Washington has a strong incentive to keep the ratings of muni bond issuers at the highest levels, knowing that these issuers badly need access to the debt markets.

“The long-term damage of a state’s default is unimaginable,” says Doe, who is confident government funds and tax revenue will support the muni bond market.



“Some states will raise taxes beyond anyone’s interest in living there,” says Doe wryly, “but, in the end, it will all work out.”

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