

# Municipals: A Core Asset for High-Net-Worth Clients

## Myths and Realities in Today's Markets

By Mark Tenenhaus

The Bond Buyer high-grade municipal 20-Bond General Obligation Index (<http://www.bondbuyer.com/news/-1027909-1.html>) was holding steady at 4.49 percent as of June 16, 2011, essentially unchanged from one year ago and suggesting that nothing important occurred of late. But this is not the case: From June to October 2010 the market dove to a 3.82-percent low, then posted a steep 157-basis-point rise to mark a year-to date peak of 5.39 percent by mid-January 2011, only to fall off again. The surge, which presented a window of opportunity to add to tax-exempt holdings, ironically rose from a wave of municipal bond fund redemptions prompted by fear and uncertainty. This “perfect storm” was the result of a flurry of negative headlines that caused financial advisors and investors to pause and question the cornerstones of municipal market investment allocations—capital preservation and the certainty of uninterrupted tax-exempt income. A tepid economic recovery on the heels of the longest and deepest recession since the Great Depression, state worker protests, unrelenting headlines regarding underfunded public pensions, threats of large-scale defaults, and potential bankruptcies roiled the municipal market, contributing to the rise in longer term tax-exempt yields from levels that bordered on generational lows last seen during the Eisenhower administration. These forces all contributed to moving municipal yields markedly higher during the first quarter of 2011, prompting investors to further question the ongoing value of the municipal asset class.

Nevertheless, the inherent value of the municipal asset class reasserted itself as bond prices rose, with yield levels declining by approximately 90 basis points by mid-June from the earlier 5.39 percent peak noted above. This rise in bond prices came about despite the same aforementioned lingering concerns regarding municipal credits and the state of the national and global economy. The fundamental core strengths of the municipal market, while challenged by this confluence of negative events and headlines, remain intact, and, in the opinion of my firm, RSW Investments, still present relative value opportunities for those willing to carefully analyze and reflect on the nature of long-term value. Interest-rate volatility remains the bane of capital preservation and investors are challenged to derive value during changing and differing market environments. What follows is an analysis of

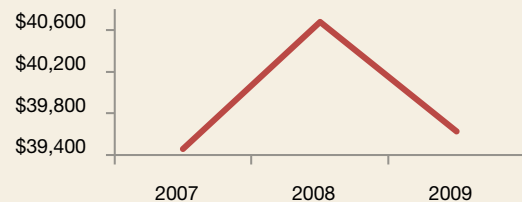
the challenges facing investors and issuers in the municipal market, and a review of why we believe that high-net-worth investors should continue to consider allocating a meaningful portion of their overall investment portfolios to the tax-exempt market as part of a disciplined investment strategy.

### Challenges Facing Municipal Investors and Issuers

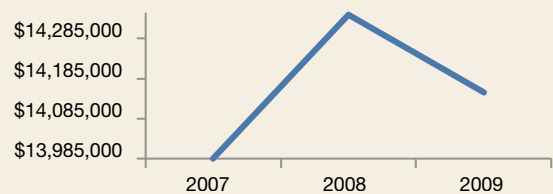
Our thesis is premised on the adage that “creditworthiness is proven in bad times, not good times.” Figure 1 shows the velocity and severity of the recent recession, which “officially” was declared over in June 2009. The steepness of the decline in personal income and gross domestic product (GDP) permeated all aspects of the national economy. Public finances have been strained severely since the recession commenced in December 2007. A recovery to prerecession revenue levels for the states is projected to occur no sooner than 2013–2014. For many states, tax revenues are still at levels consistent with receipts last recorded during 2005–2006, despite a relatively

**FIGURE 1: U.S. PER CAPITA PERSONAL INCOME AND U.S. GROSS DOMESTIC PRODUCT**

U.S. Per Capita Personal Income



U.S. GDP (millions of current dollars)



Source: U.S. Bureau of Economic Analysis



strong aggregate rise in revenues in the first half of 2011 compared to the same period last year. Nevertheless, state governments—the strongest municipal bond issuing sector—are empowered as “sovereign entities” to cure their fiscal ills. The negative cyclical economic events exacerbated the fiscal condition of those states and municipalities with already ongoing structural budget imbalances. Since the advent of the recession, states have encountered approximately \$425 billion in budget shortfalls. Such shortfalls have been addressed so far by combinations of now-expired federal stimulus monies, reserve drawdowns, tax and revenue increases, and significant expenditure cuts. Fiscal year 2012 aggregate deficits to be addressed are estimated at \$125 billion (Lav and McNichol 2011).

This does not imply, however, that large-scale defaults or wholesale downgrades to below-investment-grade ratings are forthcoming. To some degree, the spate of negative municipal headlines could have been worse. In early 2010, both Moody’s (2010) and Fitch (2010) implemented previously postponed recalibrations of municipal rating scales to the corporate rating scales. These recalibrations resulted in large-scale higher ratings, not to be considered upgrades, for most municipal issuers, including virtually all tax-backed and essential-service revenue bonds. Absent these recalibrations, many issuers—including California and Illinois—were flirting with lower and minimal investment-grade ratings.

In January 2011, as municipal bond funds encountered large-scale redemptions, the *New York Times* published a front-page article, “Path Is Sought for States to Escape Debt Burdens.” The lead sentence stated: “Policy makers are working behind the scenes to come up with a way to let states declare bankruptcy and get out from under *crushing debts* (emphasis added), including the pensions they have promised to retired public workers.” This headline and lead sentence exemplifies the negative press attached to the municipal market. The facts, however, belie these negative connotations.

Consider the following:

- All but two of the 50 states are rated by Moody’s as Aa to Aaa—only California and Illinois are rated in the A category.
- Aa to Aaa states do not require bankruptcy relief.
- High-grade investment-rated bonds in the two highest credit categories, by definition, do not have “crushing debt” (Walsh 2011).
- The issues confronting states are revenue- and expenditure-related, either structural or cyclical (in the aftermath of the recession), and are not debt-related.
- Annual debt-service payments for state and local governments amount to 5–10 percent of budgets.
- The Center on Budget and Policy Priorities (CBPP), using U.S. Census Bureau data, puts interest payments on debt as a percentage of state and local spending at 4 percent—a

percentage equivalent to 1979 figures (Lav and McNichol 2011).

- CBPP also used federal statistics to cite state and local municipal debt at 16.7 percent of GDP—a percent similar to the averages during 1980–2000 (Lav and McNichol 2011). By comparison, note that Greece’s governmental debt approximates 150 percent of GDP.

### Exaggerated Headlines Regarding Municipal Defaults and Fictitious Bankruptcy Needs

Headlines that suggest giving states the right to declare bankruptcy are alarming and sensationalist. Given the fundamental strengths of state issuers, there is no reason or justification for bankruptcy. Granting a state the right to declare bankruptcy is merely a concept that would allow states to abrogate existing contractual pension obligations. This theoretical discussion does not support the right to declare bankruptcy, because states can and are negotiating existing pension contracts. No governor supports granting states the ability to declare bankruptcy; many governors, including the governors of the two weakest states (California and Illinois), have stated that bankruptcy is an option they would neither seek nor support.

### Regarding the Potential for a High-Profile Default

The likelihood of a high-profile default is minimal; Standard & Poor’s (2010) put the prospects in perspective: “Considering California’s senior payments, and using audited 2009 data, we estimate that a 45% revenue loss (annualized) would place material pressure on the state’s ability to fund its debt service. This level of revenue deterioration would be approximately 2.5 times the average among states during the Great Depression.”

### Municipal and Corporate Bonds—All Fixed Income Assets are Not the Same

In making fixed income asset allocations among sectors, investors often yield to short-term considerations based upon current spreads without considering potential changes in relative value. Tax considerations often will impact whether assets are dedicated to either the municipal or corporate sector. However, when such considerations are superseded solely by higher current yields available in the taxable market (whether investment grade or high yield), the relative merits of the tax-exempt sector can be ignored in favor of perceived short-term value. This is especially relevant now, while perceptions of the municipal market are skewed by negative headlines, accurate as well as exaggerated.

Case in point: Corporate bonds were considered attractively priced or cheap during the recent recession. The Merrill Lynch Corporate Bond Fixed Income Index “BBB” option-adjusted spread over Treasuries stood as high as 784 basis points at year-end 2008. At the end of May 2011,

the spread had decreased to 196 basis points, a 75-percent decline. This was significantly closer to the prerecession spread of 122 basis points witnessed at year-end 2006. From year-end 2008 to May 2011, 10-year AA rated general obligation municipal yields as a percentage of Treasury bonds declined from a high of 158 percent to within their historical average range of 87 percent. Accordingly, it can be inferred that despite the negative headlines and ongoing fiscal concerns the tax-exempt market has returned to a “normal” environment. Despite recent volatility, the municipal market has delivered relatively strong and consistent long-term results. According to Barclays Capital (2011), on a taxable equivalent basis over the past 10 years municipals have outperformed all major fixed income asset categories—and equities—while maintaining lower volatility than many taxable counterparts such as U.S. Treasuries and high-yield corporate bonds.

**“ Despite recent volatility, the municipal market has delivered relatively strong and consistent long-term results. ”**

Consider that the average credit rating for the municipal bond market is in the AA range. As of year-end 2010, in the aftermath of the worst recession since the Great Depression, 65 percent of all Fitch municipal ratings were AA or AAA and about 3 percent were below investment grade. Lower investment-grade ratings (A to BBB) in the municipal market tend to be concentrated in sectors subject to competitive pressures and/or project risk, i.e., transportation, real estate, health care, etc. Moreover, high-grade municipal ratings tend to be long-standing and are less volatile than corporate bonds.

In addition, the universe of investment-grade corporate debt—especially high-grade, nonfinancial corporate debt—is significantly smaller than in the municipal market. Fewer than 1 percent of U.S. nonfinancial companies are rated Aa or better by Moody’s. Moreover, just more than 90 percent of nonfinancials are rated from as low as A3 to C, with the majority lower than investment grade. In Fitch’s corporate rating distribution as of year-end 2010, 3 percent was AA, 32 percent was below investment grade, and 41 percent was BBB or minimal investment grade.

Are similarly rated municipal bonds and corporate bonds really comparable? Consider that states and municipalities have the ability to cut spending without unduly reducing their ability to generate tax revenues, whereas similar expenditure cuts by a corporation typically would reduce revenues by

cutting production and/or services. Municipalities also have a greater (but not unlimited) capacity to increase taxes and fees than corporate issuers, who are limited in the ability to raise prices subject to competitive market pressures. The 66-percent and 46-percent increases in Illinois personal and corporate tax rates, respectively, in January 2011 illustrate this ability. In addition, corporations and individuals are mobile, but governments are essentially monopoly providers of municipal services and therefore not subject to mergers or going out of business.

#### Default Rates

A Standard & Poor’s (2011) non-housing municipal default study identified 42 municipal defaults during 1986–2010. Of this number, 40 were noninvestment grade immediately before the default. The rating agency cited 63 housing defaults over this same period. To the best of our knowledge, no investment-grade municipality has defaulted during 2011 to date. Based on data from three rating agencies, Fitch reports that the default rate for all rated municipal bonds (including below investment grade) over the past 10 years is a paltry 0.03 percent. The last state to default was Arkansas, in 1933. Today, Arkansas is among the fiscally best-performing states; it concluded fiscal year 2010 with a \$1.8 billion unreserved ending fund balance.

Moody’s cites approximately 2,000 defaults by nonfinancial companies since 1930, an average annual default rate of approximately 2 percent—roughly 66 times greater than the 0.03-percent municipal default rate noted above.

#### Looking Ahead: Active or Passive Municipal Portfolio Management in a Volatile Market

Individual investors typically display various degrees of risk tolerance, especially with regard to credit. In the municipal market, however, with its relatively strong credit attributes, the potential impact of higher rates on portfolio valuation (aka interest-rate risk) often is the bane of investors. Capital preservation, as well as consistent cash flow, is the dominant objective. Financial advisors can offer a host of financial strategies to meet these goals while minimizing credit risk and providing protection against rising interest-rate risk. Passive strategies may include creating maturity ladders or the simple construction of portfolios that “barbell” shorter and longer maturities. Such strategies often require investment in longer maturities to provide cash flow and therefore may be more sensitive to rising interest rates and/or a steepening of the yield curve. The significant yield difference between short- and longer-term municipal yields also implies that significant income may be sacrificed when using this type of strategy.

More active portfolio management with an emphasis on total return may seek premium or “cushion” bonds in intermediate maturity ranges with specific call features that meet duration targets that offer enhanced relative value. Such




active management also should emphasize disciplined sell strategies to maximize returns and take advantage of price dislocations or discrepancies in the prevailing market. This is accomplished by increasing or decreasing the portfolio average maturity and duration (i.e., measure of interest rate sensitivity) using premium-coupon callable bonds. The goal is an optimally structured portfolio with respect to risk-adjusted returns as interest rates increase or decrease over time. This strategy often also can aid in credit diversification because investors in weaker-rated states often can forgo the tax advantage of home-state municipals by investment in select premium out-of-state securities.

### No Time for Complacency

Municipal credits, as a sector, remain strong. However, the challenges faced by individual issuers are many, and client concerns have been heightened by recent events and headlines. Financial advisors are well-served to remember that the municipal portion of a client's holdings often is the entire safety net of a client's portfolio and net worth. Therefore, emphasis on capital preservation in this portion of the portfolio's allocation is crucial. Capital preservation is accomplished by careful security selection and portfolio management—and by the ongoing review of the specific circumstances of each individual issuer in a market consisting of more than 40,000 issues. In a volatile market environment, the stereotypical “buy and hold” nature of these investments becomes problematic. Active investment management can maximize yield while minimizing interest-rate risk. Financial advisors are not expected to be credit experts, but a fundamental knowledge of the issues affecting the market and individual issuers, both positive and negative, is important to maintaining capital value.

In short, all bonds are not the same. In the near-term, we anticipate that credit downgrades will continue to outpace upgrades. Therefore, we believe portfolio selection should emphasize high quality “household” names as liquidity narrows for less-visible issuers, especially as the industry continues to consolidate. The implosion of the municipal bond insurance industry contributes to weaker liquidity. The recalibration of municipal ratings to higher levels also compressed credit spreads, masking much of the comparative differences among issues. A rudimentary understanding of credit factors that would impact near- and long-term outlooks of client holdings should include the following considerations:

- economics and demographics
- unfunded pension and other postemployment benefits (OPEB) liabilities
- capability and willingness to reduce expenditures on a timely basis
- negative fund balances and depleted reserves
- liquidity and cash flow weakness

Providing investors with a thorough explanation of the issues affecting the municipal asset class—a large core holding of most high-net-worth portfolios—is crucial. The recent volatility in the municipal market suggests that financial advisors who are not specifically focused on this large and complex asset class may better serve their clients in the long-term by seeking the services of municipal market professionals who maintain disciplined investment strategies specifically focused on high-quality credit selection, ongoing credit review, and active yield curve management. 

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