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Why Insured Municipal Bonds are Staging a Comeback.

Since 2005, the percentage of municipal bonds that are insured has plummeted. But, it's recently started to rise.

After a long dry spell, we are starting to see renewed interest and growth in the insured municipal bond market. For investors, the promising outlook may be due to the recent outperformance of insured bonds relative to uninsured bonds. For financially troubled municipal issuers, the recent credit-rating upgrades by Standard & Poor's (S&P) of two large bond insurers has aided the growth of the insured municipal bond market.

Signs of growth in the market

In 2005, the percentage of municipal bonds that were insured was 57%; in 2012, it was 3.5%. Why the dramatic fall? Bond insurers were obligated to pay for underperforming or defaulted structured-finance instruments (i.e., mortgage-backed securities) that they insured during the financial crisis in 2008, which weakened the financial condition of the insurers.

Today, insured municipal bonds are showing strong signs of a recovery. The percentage of municipal bonds that were insured in 2013 increased to 3.9% (the first annual increase since 2005.), and the rise has continued this year, hitting 4.3% as of April 30, 2014. Bond insurers expect the insured market to increase to 7.0% to 8.0% of issuance later in 2014.

At the same time, the rating agencies are more bullish on the companies that insure municipal bonds. S&P upgraded two of them in March: Assured Guaranty (AA/stable) and National Public Finance (MBIA) (AA-/stable). The upgrades were supported by the insurers' strong capital levels, good operating performance, a decline in their legacy structured-finance portfolios and their payment of claims for recent high-profile municipal bankruptcies. Higher credit ratings will help support the insured municipal market by increasing the value of bond insurance and will also make bond insurance more attractive to issuers by lowering borrowing costs.

Why consider insured municipal bonds?

Municipal bond insurance does not cover market risk due to interest rate movements, but it can help investors reduce credit risk in an overall portfolio. Based on current pricing of selected Detroit and Puerto Rico credits, investors can see the value of municipal bond insurance. The table below shows that credits wrapped with insurance from Assured Guaranty performed 20+ points better than the same uninsured bonds following Detroit's bankruptcy and the selloff of Puerto Rico bonds over their financial concerns.

Conclusion

After experiencing years of decline, we believe the insured portion of the municipal bond market is staging a comeback. Suitable investors in higher tax brackets may wish to talk to their advisors about adding insured municipal bonds to their long-term fixed income allocations.

Sources

The Bond Buyer, “Bond Insurance: Then & Now: The Revival of an Industry,” April 30, 2014
Citi, “U.S. Municipal Strategy Special Focus: The Return of Monolines,” March 28, 2014
Bank of America Merrill Lynch, “Municipal Weekly,” May 2, 2014
Standard & Poor’s, “U.S. Bond Insurance and the Financial Guarantee Sector Stand at a Crossroads”
Important information

Municipal securities are subject to the risk that legislative or economic conditions could affect an issuer’s ability to make payments of principal and/ or interest.

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