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Will Tobacco Bonds Go Up In Smoke?

Tobacco bond yields can be addictive, but price volatility and default risk could make you ill.

Municipal tobacco bonds are one of the largest and most liquid segments of the high-yield muni bond market. They can offer enticing yields and periods of extraordinary returns. However, those features also come with high levels of price volatility. And because their repayment is dependent on cigarette consumption — and consumption is going down faster than expected — future defaults are almost certain, although perhaps not for a few years. So, are tobacco bonds good for investors or are they likely to go up in smoke?

How tobacco bonds came to be

The vast majority of these bonds were issued between 1998 and 2007, following the tobacco company settlements with 46 states to compensate for damages incurred due to smoking. States agreed to drop any future litigation against tobacco companies in return for annual payments based on cigarette consumption, subject to certain adjustments. Many states decided to securitize the future revenue stream and offload the risk of declining consumption — and future tobacco company solvency — on investors through the issuance of bonds. Today, tobacco bonds represent close to 20% of the Bloomberg Barclays High Yield Municipal Bond Index.

Will smoking declines snuff out payments?

Because of its addictive nature, smoking was initially thought to be fairly inelastic and unaffected by price increases that tend to depress demand in other products. This resulted in bond securitization structures that assumed fairly low levels of annual consumption declines. However, since the initial issuance, cigarette tax increases and stronger governmental regulation — including smoking bans in bars and restaurants — have combined to accelerate a decline in smoking.

The resulting declines in cigarette sales have been more severe than initially modeled in earlier tobacco securitizations and may portend future defaults. But as long as people are smoking cigarettes and the tobacco manufacturers remain in business, the odds of ultimate recovery may be higher than in other defaulted municipal bond situations — even if repayment is much later than scheduled maturity. This is because the pledge of securitization payments by the tobacco companies is perpetual.

Tobacco bonds rally, then decline

The characteristics that attract buyers to the tobacco bond sector — namely the size and liquidity — also largely explain the high levels of volatility when things turn. The most recent period of outflows that began in October 2016 and accelerated following the national elections is a good example of how quickly things can turn for valuations in the tobacco sector.

After years of consistent declines in cigarette sales, cigarette usage in 2015 was largely flat —

reportedly due to increased consumer discretionary income as a result of falling gas prices. This set in motion a strong rally in tobacco bonds that lasted from September 2015 to October 2016. During this time, the tobacco sector of the high-yield index was up an impressive 21.7%. But for November 2016, tobacco bonds were down more than 9%, outpacing the overall high-yield index, which was down just under 6% for the month. The sector continued to demonstrate its volatile nature as we entered 2017, returning 10.86% through February 2017, significantly outperforming the overall high-yield index return of 3.82%.

Bottom line

We maintain a negative view on the tobacco bond sector. The availability of higher yield and the sector's strong potential for ultimate recovery — even if not at the originally scheduled bond maturity — can justify some limited exposure to tobacco bonds. However, since price volatility can be significant, only those portfolios with a very high risk tolerance should have exposure to this sector.

By Columbia Threadneedle Investments on March 6, 2017