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Who Buys Municipal Bonds And Why.

As a student of municipal bond defaults I was mystified for many years by the question of why individual investors chose to invest heavily in low yielding municipal bonds. The main attractions touted by them was their freedom from federal income taxes, but this did not explain why so many retirees and individuals of limited taxable income also chose to make muni bonds a significant part of their investment portfolio. In fact, many made this their entire venture into securities investing.

I believe the attraction of municipal bonds lies in how they where sold, that is as a very safe security that served a public purpose and rewarded you with the added bonus of being tax exempt. In fact, the tax exemption feature is overly valued by even individuals with modest taxable income because, as one retired investor told me, they simplify your life. What he meant by this is that he could ladder his monthly income flow with munis without worrying about the state of the economy or the stock market or about the need to file a tax return and disrupt his routine by suddenly having to file a tax return or come up with money for a tax payment. Until we reach those golden years, we fail to realize that people reach a point where getting to bed at 10 PM each night and not have a worried sleep is worth accepting a lower but steady return. Munis, CDs and annuities find a home among such investors despite each products unfavorable features.

Note however that there will always be investors who want their cake and eat it too. Such investors become the owners of municipal bonds sporting seven and eight percent coupons. They want equity returns and think the low risk attributed to munis is generic. Underwriters have taken advantage of this misconception to peddle junk debt issues labeled as municipals which could never be sold without the aura of a municipal authority. Yes, the offering statements usually make this all clear because they know that investors won't read them. Want to start a nursing home chain, housing project or environmentally friendly project all without a dime of equity? Offer them an 8% municipal bond issue and they come running. Build in a two or three year debt reserve and you're golden. The list of horror stories and even outright fraud is endless. Even opting to invest via a muni mutual fund is little protection since they have to compete for funds and payout percentages are what counts with these folks.

One abuse gaining a lot of traction are bonds issued to fund a municipalities pension funding obligation. Imagine a governmental entity that pretends it can borrow money and reinvest it at a higher rate of return than it pays out. If this were true, wouldn't we fund all government spending that way? The facts are that government is sucking in 'prudent investors' so that when the day of reckoning comes with its public employees, bondholders and pensioners it can stiff some 'fat cats' who thought they could profit from the labors of government employees who, incidentally, they have been lying to for decades. Were this not the case, municipalities would be issuing their bonds directly to the pension funds thereby earning the pension funds a higher rate of return. But this would of course would not do since it leaves out the underwriters and their fees, and we can't have that. But then capitalism has never been about fairness, has it?

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