Bond Case Briefs

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Avoiding Redemption Risk In This New Municipal Environment.

Summary

- Growing threats to Municipal bondholders.
- Little known provisions can lay waste to bond values.
- Recommendations and strategies to escape getting burned.

Municipal bond issuers are under increasing pressure to fund their ballooning pension costs. Red flags are abundant in muni-land right now since many public entities are selling their assets – sewer and utility systems among them. Some are even merging with private entities to fund their growing liabilities. These types of transactions can have enormous negative repercussions and should put municipal bond investors on high alert. Specifically, investors should fear the triggering of Extraordinary Redemption Provisions (ERPs), explained below. I'll also recommend safe alternatives to buy, what to avoid, and what steps do-it-yourself investors can take to reduce risk in the muni market.

Significant events involving one of your municipal bond issues can trigger Extraordinary Redemption Provisions. This provision appears in the municipal bond's Official Statement. It states that if a certain event occurs, the issuer can redeem the bonds early. Sometimes this redemption can occur at par value $100, which can have huge downside ramifications for those who own bonds trading at a premium (above $100). ERP trigger events include unexpended proceeds, determinations that the status of the bonds are no longer tax free, changes in uses of proceeds, failure of issuer to appropriate funds, or destruction of facilities from which the bonds are payable. These events can cause massive losses if your bond has appreciated in market value and trades at a premium, such as $120. That premium can be lost in a heartbeat unless you have done the proper credit analysis.

Although this still happens only rarely, it has become more frequent of late. We are increasingly seeing privatization of municipal assets, as the issuers strain to fund their pension liabilities. We see this with water and sewer bonds. These were once considered the gold standard of the muni market. They were essential services, isolated from a municipality's pension liabilities. As some move from public to private they become far riskier.

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Seeking Alpha

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