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Bonds: Beware This Major Flaw in Moody's Rating System.

The fallout from Detroit's bankruptcy filing has investors – and even ratings agencies – questioning the validity of the bond rating system.

Now investors need to know if it can be fixed in a way that actually helps those investing in general obligation (GO) bonds.

In June, Detroit Emergency Manager Kevyn Orr sent the financial equivalent of a nuclear blast through the muni bond markets when he stated that holders of Detroit's GO bonds – whose holdings total roughly $600 million – will be lumped together with other unsecured creditors who collectively account for $11 billion in city obligations.

Historically, GO bonds were seen as the safest form of municipal debt. That's because historically municipalities would raise taxes, cut services – do anything – rather than force losses on bondholders.

"The bottom line is, Orr said that these bonds are unsecured, which potentially forces a loss on these investments," explains Money Morning Chief Investment Strategist Keith Fitz-Gerald. "If that's the case, then here we go: those formerly secured debts are in fact no safer than junk bonds. Which means, all of a sudden, in the blink of an eye, all the ratings on municipalities everywhere are suspect."

Already under pressure from having misjudged the entire financial crisis, ratings agency Moody's Corp. has proposed changes on how they will rate local governments' GO bonds thanks to Orr's not-so-subtle push.

Moody's suggests doubling the weight of pension debt in the rating criteria from 10% to 20%. It reduced the "economic factors" weighting from 40% to 30%. It also introduced a scorecard for U.S. local governments to boost the transparency of the rating process.

Moody's stated that increasing the emphasis on pension debt will recognize that both pensioners and debt holders have "enforceable claims on the resources of local governments."

But Moody's also stated the modifications likely won't affect a vast majority of the 8,200 local governments that it rates, which begs the question…

How much can investors rely on Moody's rating system?

Bond ratings are supposed to reflect whether or not the issuer will be able to meet payment obligations, but Detroit's bondholders could be left with mere pennies on the dollar – a risk they didn't realize they were taking.

Here's what Moody's is missing – and how you can avoid ratings pitfalls but enjoy bonds' high yield…

Investing in Bonds: What to Do About Ratings

“If there’s one thing we’ve learned from the Detroit failure, it’s that the ratings system is absolute crap,” says Fitz-Gerald. “Moody’s has perpetually underestimated the impact of the most out-o--control aspect of most municipal spending: employee wage levels and pension obligations.”

In the past, the wage levels (debt and pension) were at around 10% consideration; upping it to 20% doesn’t have Fitz-Gerald convinced the rating system’s accuracy will improve.

“I think the percentage should be higher because the municipalities are paying arguably huge pensions,” he says. “As long as that’s part of the ratings criteria, it seems to me pensions should have a higher weighting when it comes to ratings.”

At the same time, Fitz-Gerald still sees the ratings as something investors must consider.

No matter how the agencies ultimately account for municipal liabilities, there is no way around the system’s flaws. According to Fitz-Gerald, Detroit’s muni ratings are going to be like “the proverbial canary in a coal mine.”

So where does that leave those investing in muni bonds?

Right now, investors can nab many munis at bargain prices. Detroit’s bankruptcy thoroughly spooked investors and the muni bond prices plunged.

“I am against conventional wisdom on munis at the moment,” says Fitz-Gerald. “They have been beaten down so far that the income is extremely appealing… assuming investors manage the risks appropriately.”

That means check the ratings system, but be aware of its limitations. Take a look at the track record, stability, and management tenure before even beginning to consider individual bonds.

“If you’re going to pick individual bonds, you want to stick with areas that are generally prosperous and growing, versus areas that are failing,” Fitz-Gerald explains. “For example, I wouldn’t buy any muni bonds in California right now; on the other hand, as an extreme example, some tiny town in the middle of North Dakota situated in the fracking boom might be a pretty good bet.”

Finally, investors absolutely cannot approach blindly when investing in muni bonds, as they might have in the past. Therefore, make sure you’re aware of what it is you want to achieve, and the losses you’re willing to sustain. This is part of having a carefully planned and structured portfolio.

“The return of your money is much more important than the return on your money in today’s market,” Fitz-Gerald points out.

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