
Reuters: How to Navigate the Troubled Municipal Bond Market.

Oct 15 (Reuters) – If you can avert your eyes from the federal government's budget and debt-ceiling crisis, you may spot more trouble ahead in the state and local municipal bond markets.

Detroit's bankruptcy, Puerto Rico's fiscal woes and unfunded pension liabilities in other states and cities are giving the nearly $4 trillion muni bond market the jitters. Investors have been yanking money out of muni bond funds for more than seven months – triggering redemptions of almost $50 billion since March, according to Morningstar.

That beats the nearly $45 billion in outflows from November 2010 to August 2011, when some soothsayers were predicting massive defaults based on weakening state and local finances and pension liabilities. And the exodus is far from over as the muni bond market heads for one of its worst years in the past half decade.

If you're an income-oriented investor in this market, it's high time to look for safer ground. You need to be conscious of credit quality, the fiscal condition of the bond issuers in your portfolio and maturity dates.

The tried-and-true route is to go short on maturities and high on credit quality. Bonds that mature in under three years have the least amount of risk and volatility, though they also pay the lowest yields. Exchange-traded funds and mutual funds offer you a basket of different issuers, so you avoid concentrating too much risk in a small number of bonds.

One fund that invests in short-maturity munis is the iShares short-term National AMT-Free Municipal Bond ETF, which invests in an index of short-maturity bonds.

With a yield just under 1 percent, the iShares fund charges 0.25 percent annually for expenses. The fund has gained 0.26 percent, compared with a 2.6 percent loss for the Barclays Municipal Total Return Index through Oct. 14.

A worthy alternative is the SPDR Nuveen Barclays Capital Short Term Muni ETF, which offers a slightly higher yield at 1 percent and slightly lower expense ratio at 0.20 percent. It's up 0.02 percent for the year through Oct. 14.

As always, credit quality is also critical to avoiding possible defaults. You have to concentrate on issuers who are in good financial shape in areas that support economic growth.

Marilyn Cohen, co-author of "Surviving the Bond Bear Market" and chief executive officer of Envision Capital Management in Los Angeles, suggests sticking with the best-quality bonds rated AAA down to A-.

"You aren't getting paid enough to go into low credit quality," she says.

Use more than one broker to seek out munis, she says, because prices and yields can vary from broker to broker by 1 percent to 5 percent.

What kinds of individual bonds offer the lowest default risk? “The safest municipal bond investments are crème de la crème credits,” Cohen says. They include “essential-service water, sewer and irrigation munis in good areas with growth.”

Other strong issuers include “essential large airports; senior liens and issuers that didn’t buy Wall Street’s interest-rate swaps,” she says.

The Detroit bankruptcy is the most high-profile trouble spot in the muni market, and it’s worth watching carefully as a sign of things to come. That’s assuming, of course, that the big gorilla issue of Congress potentially breaching its debt-ceiling deadline on Oct. 17 doesn’t sabotage global credit markets.

How will the bankruptcy court treat the Motor City’s general obligation bonds? If it’s decided that creditors will get only pennies on the dollar, that could hurt other city-issued bonds, especially those with large pension debts such as Chicago’s.

During the past decade, general obligation bonds, which are regarded as the safest issues, represented 60 percent of the total muni market. What will happen to Chicago bonds if Detroit is allowed to write down its general obligation debt? Puerto Rican bonds are also in trouble; the U.S. territory has $70 billion in debt and holds an estimated $33 billion in pension liabilities.

As if that weren’t enough to worry about, you also need to keep an eye on the Federal Reserve’s interest-rate policy.

If the Fed decides to “taper,” or back off its easing policy of buying Treasury bonds, that could lead to another round of interest-rate increases. That, in turn, could trigger another round of muni selloffs and punish those holding higher-yielding bonds and investors in ETFs and mutual funds, especially funds that hold intermediate- to long-maturity bonds.

By John Wasik