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In a Tale of Two Muni Markets, it's Far, Far Better for Advisers to Find the Middle Ground.

Neither the best- nor worst-case scenario is accurate and that means credit analysis is more important than ever.

Charles Dickens' famous first line of "A Tale of Two Cities" — "It was the best of times, it was the worst of times" — could have referred to investors' views of U.S. cities and the municipal bond market in 2013. The best of times reflects the apparent laissez-faire attitude of many market participants toward credit analysis and the worst of times in the hysteria that every city could become the next Detroit.

As usual, the truth lies somewhere between the two extremes. Advisers should encourage tax-exempt bond market investors to stick to this less-traveled middle road.

In the 1970s and early '80s, before municipal bond insurance, many states submitted financial statements less than 10 pages long — including all the notes. Investors and their advisers largely relied on the opinions of ratings agencies. Subsequently, bond insurance provided investors with an extra level of perceived protection and also boosted transparency, as bond insurers were among the first to call for greater disclosure from states and municipalities.

The downside: Investors became even more lackadaisical about credit analysis. Too often, investors said, "As long as I buy AAA insured municipal bonds, I don't have to worry about credit risk."

The implosion of the bond insurers in the 2008 financial crisis put a temporary end to the widespread "set it and forget it" philosophy. Today, advisers may hear investors say, "As long as I buy A or AA general obligation bonds, I don't have to worry about credit risk." We've gone two steps forward, only to take a giant step back.

What causes municipal bond investors to fool themselves into thinking credit analysis doesn't matter? Corporate bond investors typically don't take such a cavalier attitude toward credit risk. Perhaps events such as mergers, which can cost bonds their investment-grade status overnight, have made taxable-bond investors more circumspect in their research.

In an odd juxtaposition with the casual attitude toward credit risk, many municipal bond investors have become paranoid about the financial condition of states and municipalities. Such hysteria makes for good headlines and causes restless nights — but also misses the target.

Municipal investors have to cope with today's elevated, sustained levels of media attention. Triggered by the 2008 financial meltdown, the municipal market has faced one negative headline after another. Bond defaults. Predictions of billions of dollars in additional defaults. High-profile bankruptcy filings by Detroit and other cities. Fearmongers see Detroit's July bankruptcy protection filing as a harbinger of things to come. But while other cities share some of the same problems, the breadth and depth of Detroit's issues sets it apart.

As a practical matter, it should be obvious that neither the best- nor worst-case scenario accurately portrays the U.S. municipal market. Less obvious is which scenario investors should fear most. Headline-driven hysteria may cause sleeplessness and high blood pressure, but it promotes a higher awareness of the importance of credit research.

Although the “worst of times” scenario is exaggerated, serious stresses remain at both the state and local levels. In fact, investor reliance on the “best of times” approach potentially is more damaging to portfolios. Investors who assume that all tax-exempt bonds rated A or better are safe risk exposing themselves to unwanted surprises. One doesn’t have to experience a default to feel the effects of such surprises. Deteriorating credits can whittle away at a bond’s value.

So far this year, the multiple-notch rating downgrades of several highly rated bonds, both in the general-obligation and essential-purpose-revenue categories, have cost investors as their prices fell to reflect the increased credit risk. These actions have reflected ratings agency views on deteriorating financials, poor management, and/or the lack of political will to take prudent actions, among other factors.

Advisers can best help investors through diligent, credit-centric security selection, considering all aspects of the issue before purchase and maintaining a strong surveillance system to mitigate unpleasant surprises. Investment advisers who focus on credit analysis should have a better chance of avoiding credit debacles and might even uncover issues with trends the market doesn’t yet reflect.

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