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State Pension Problems Create Hidden Muni Risks.

Traditionally, investors seeking retirement income have put a significant portion of their assets into municipal bonds.

After all, the risks are supposedly low, and the income is free from federal income tax. That's an important consideration for those in a high tax bracket even after retirement.

But today I'd like to issue a stern warning for all upcoming retirees…

In the current low-interest-rate environment, the risk-return tradeoff for muni bonds is downright frightening.

America's Growing Gap

Across the country, state pension fund deficits have yawned since the 2008 financial crash. And the problem has only appeared to lessen recently because of the Fed-fueled stock market rise. When the Fed normalizes interest rates, it's likely that the stock market will normalize, too, which will further increase state pension fund deficits.

If a recession occurs at the same time, it's unlikely that state revenue will be able to cover pension fund holes… As a result, numerous state and municipal bankruptcies could occur.

If you want to see the kinds of losses muni investors could face if things go wrong, look no further than Detroit's recent bankruptcy.

Even the most senior general obligation bondholders received just $0.74 on the dollar, while more junior bondholders received as little as one-third of their money. Municipal pension recipients, meanwhile, were almost fully protected.

It also doesn't help that valuable assets – in this case, the $8-billion Detroit municipal art collection – proved impossible to liquidate for the benefit of bondholders. That failure reversed the deal bondholders thought they had, where senior debtholders were supposed to rank ahead of almost everybody except the IRS.

Editor's Note: Muni bonds sure look hazardous – but where are investors supposed to turn? Well, did you know there's a brand-new, private currency sweeping America right now? One simple investment could net $56,700 in the next 9 to 12 months. But you must act fast to maximize your gains…
So where are the biggest pitfalls right now?

According to a Bloomberg report, 2013's worst state pension-funding gap was in Illinois, where state pensions are 39% funded. Kentucky (44% funded) and Connecticut (49% funded) weren't far behind. New Jersey (64% funded) ranked 17th worst. But more recent 2014 data, calculated on a new accounting basis with less "smoothing" of investment returns, suggests that New Jersey pensions were only 28% funded.

The problem is widespread, with only six of 50 states more than 90% funded. Naturally, investors should avoid the states with the biggest gaps – especially when bonds from the country's worst-funded state only yield a little over 2% for a 10-year maturity, according to Municipalbonds.com. That yield (which barely covers inflation) carries considerable price risk should interest rates rise. And in no way does it compensate investors for the Illinois default risk.

Plus, investors once had an additional advantage when buying their own state's municipal bonds – interest is free from both state and federal income tax in that instance – but today's ultra-low interest rates have mostly destroyed that benefit.

Consider Illinois' 5% income tax rate, for example. An Illinois resident only receives an additional 0.1% (2% x 5%) yield on an Illinois state bond compared to an out-of-state buyer.

Meanwhile, there's another factor investors often overlook: If the state gets into financial trouble, taxes on residents will undoubtedly be raised, much as they were in 2011 when the state income tax rate rose from 3% to 5%.

Few, if Any, Investments Worth the Time

Finally, investing in truly safe municipal bonds doesn't seem worth the effort, either. The Wells Fargo Advantage Wisconsin Tax-Free Fund (SWFRX), for example, invests in the obligations of that fully funded state, but offers a measly 1.4% yield from doing so. While the fund managed a satisfactory 6.9% return in 2014, that gain was the result of a general decline in interest rates; at current levels, the fund is extremely vulnerable to a general rise in rates.

Oddly enough, one area where you may do better is in high-yield municipal bonds. These assets focus on revenue bonds related to somewhat-risky municipal-backed investments. Naturally, some of these investments will fail. A recent famous case involved a waste incinerator constructed by Harrisburg, Pennsylvania that suffered a two-fold cost overrun. It caused the city to default on $280-million worth of debt.

Still, the risk from rates rising is somewhat less on these bonds, because their yields are already far above the Treasury bond yield. Plus, the tax exemption is naturally worth more when you're receiving more interest.

One potential investment is the T. Rowe Price Tax-Free High Yield (PRFHX) bond fund, a $3.4-billion fund that yields a solid 4%. It has also outperformed the Lipper High-Yield Municipal Bond index over the last 10 years. The fund invests in a very broad range of obscure municipal bonds, and the biggest holding is just 1.3% of assets. The risk, therefore, is diversified. Though a deep recession would doubtless affect it badly.

In general, though, given the risks involved and the modest size of their tax benefit at current yields, municipal bonds aren't an especially good deal right now.

Good investing,

Martin Hutchinson

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