

Bond Case Briefs

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Getting Tested Again: Municipal Bond Funds Face More Stress.

NEW YORK — Here we go again.

One worry after another has hit the municipal bond market in recent years, from a high-profile 2010 prediction for a wave of defaults to Detroit's 2013 bankruptcy filing, the largest in U.S. history.

The latest concern is actually an old one: The governor of Puerto Rico said last month that the island, whose economy and population have been shrinking for years, may not be able to repay its \$72 billion in debt. That's significant because half of all muni-bond funds have some Puerto Rican bonds.

The market for bonds issued by local governments, water utilities and school districts is a notoriously emotional one, dominated by individual investors who have been quick to sell when anxious. That can amplify price drops, and investors have been pulling out of muni-bond funds in recent weeks.

But as with each recent challenge, managers of muni-bond funds expect the market to power through. Even though most funds own Puerto Rican bonds, the average amount is 3.4 percent of total assets, among funds with any at all. For half of those funds, it's 1.4 percent or less, according to data from Morningstar.

It's a separate worry, which is still looming, that may lead to bigger difficulties: rising interest rates.

"Puerto Rico is a problem in and of itself," says Lyle Fitterer, who helps oversee \$39 billion in muni-bond investments at Wells Fargo Advantage Funds. "It's not going to have a spillover effect on the broader municipal market."

PUERTO RICO PORTIONS

One of the main draws for municipal bonds is that their income is free from federal income taxes.

Puerto Rico is a special case because income from most of its bonds is also free from state and local taxes for people living California, New York and other states far from the Caribbean. Nineteen municipal-bond funds have 10 percent or more of their assets in Puerto Rican bonds, mostly ones that focus on single states or high-yield bonds.

Worries about Puerto Rico, along with other factors, drove investors to pull \$1.6 billion out of muni funds in May and June. It marked the first monthly withdrawals since 2013. Even so, muni funds have drawn \$29.7 billion in net investment over the 12 months through June, according to Morningstar.

Analysts pay close attention to these numbers because individual investors drive the market. After the much-publicized 2010 predictions for a coming wave of defaults, for example, nervous investors

dumped their muni funds. Their pullout forced managers to sell bonds to raise cash to return to investors, which pushed prices lower and spurred even more investors to head for the exits.

LITTLE SPILLOVER

But the troubles for Puerto Rico have not hurt prices of other municipal bonds much.

Even though some areas of the country are also under financial pressure, such as Chicago, tax revenues for local governments are generally improving.

"It's amazing how the market has shrugged off these problems, but there is a thirst for fixed income that seems insatiable," says Josh Gonze, portfolio manager at Thornburg Investments, which manages about \$10 billion in municipal bonds. "The market is saying, 'We'll pass on Puerto Rico and the Detroit and Chicagos, but we'll buy everything else.'"

The average intermediate-term, national municipal bond fund is down 0.4 percent over the last three months.

RATE EFFECT

The reason for the price drops during the spring may not be what investors expect.

Although many blame the problems in Puerto Rico, Chicago and other hot spots, "it's really because interest rates are moving higher," Fitterer says.

Higher rates pull down existing bonds' prices, because their yields are suddenly less attractive than those of newly issued bonds. And muni yields are higher than at the start of the year, following the lead of Treasuries. Many economists expect the Federal Reserve to begin raising short-term rates later this year.

Warnings have been circulating for years that bond prices could be in for a sharp slide, once rates rise. Even if it shouldn't happen, muni fund managers acknowledge that some investors may react to a Fed hike by immediately selling in hopes of avoiding losses.

Some fund managers have increased the cash in their portfolios, which would enable them to take advantage and buy low during a sell-off. Gonze's Thornburg Intermediate Municipal fund has 18 percent in cash, up from about 5 percent two years ago, for example.

If a sell-off occurs, managers say it could be short and shallow. Joe Baxter, head of the municipal bond group at Delaware Investments, points to 2004, the last time the Fed began a series of rate hikes. The funds he oversees all rose in the ensuing year.

"You can sit there, waiting for an event," Baxter says, "but then you're missing a chance to keep earning income in a market that's 95 percent good."

Just don't expect the returns to be very big. Yields are low - close to 2.25 percent for a 10-year municipal bond - which means returns will likely be too.

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