[Bond Case Briefs]

Municipal Finance Law Since 1971

[Municipal Bonds Still Considered Safe, Despite Some Ailing Governments.]

Puerto Rico is drowning in $72 billion of debt it admittedly cannot pay back. Several states — Illinois, Pennsylvania, New Jersey and Kentucky among them — are facing mounting financial problems of their own, mainly because of pension promises that are not properly funded.

Those government travails come just two years after Detroit's historic bankruptcy, the largest municipal default ever.

Since individuals hold most of the $3.7 trillion invested in municipal bonds — or about 70 percent, either directly or through mutual funds — it raises the question: Should investors be worried? After all, municipal bonds have traditionally been viewed as safe investments.

"There is more stress in the muni market today than there was 10 years ago because there are higher fixed costs like pensions and retiree health care costs, increased debt costs and more modest revenue increases," said Lisa Washburn, a managing director for Municipal Market Analytics, a research firm based in Concord, Mass. "I am more worried about credit deterioration in states with significant pension issues, but I am not at this point concerned about any risk of default at the state level."

Overall default levels remain exceedingly low and are not expected to rise meaningfully. The default rate of the S&P Municipal Bond Index, which tracks 84,000 bonds from more than 22,000 issuers, was 0.17 percent in 2014, compared with about 0.11 in 2013.

"We expect to see a small increase from the past in terms of bankruptcy or restructuring, but we have to put this in perspective," said Christopher W. Alwine, head of Vanguard's municipal bond group. "It's a few isolated events in a very large market."

Still, the pension problem isn't going away anytime soon. Cities, counties and states will continue their struggle to find the most politically palatable and financially feasible ways to shore up their finances. In some cases, governments have issued more bonds to fill in the pension shortfall, which feels a bit like resorting to a credit card to cover the daily bills.

A recent analysis by the Pew Charitable Trusts found that state and local pensions had a funding gap of $1 trillion.The Illinois pension system, for example, was only 39 percent funded in 2013, according to the report, and the Kentucky system was just 44 percent funded.

"Some states have big pension problems, but they also have a lot of power to manage expenses and raise revenue," said Al Medioli, head of credit policy for the public finance group at Moody's Investors Service. "Some local governments are having a harder time."

The ability to raise taxes has played a large part in keeping overall municipal bond default rates so low — and has contributed to the perception that muni bonds are generally solid investments. General obligation bonds were issued by municipal governments and backed by their "full faith, credit and taxing power," and investors in such bonds had the legal standing to seek a court-ordered tax increase if that is what it would take to prevent a default. Even in the extremely rare case when a municipality filed for bankruptcy, general obligation bondholders typically recovered most or all of their money, bond analysts said.

But in Detroit's bankruptcy, that didn't happen. General obligation bondholders recovered at most only 74 cents on the dollar and in some cases less, while many so-called revenue bondholders were not hurt. Revenue bonds, like those issued by a sewer authority for a new treatment plant, are repaid with a dedicated stream of revenue generated by that authority. As result, some bond managers and investors, both large and small, are shunning general obligation issues in favor of revenue bonds.

"This is the flip of what was taught in Bonds 101," said Marilyn Cohen, president of Envision Capital Management in El Segundo, Calif., who manages bond portfolios. "Everything we have been taught about general obligation bonds, that the issuers have the unlimited ability to tax the people and pay the bonds, we learned that is false."

Peter Hayes, head of BlackRock's municipal bond group, called it the emergence of a dangerous precedent. "If you look at Detroit, it was really more about politics than the law," he added.

In the bankruptcy of Detroit, as well as with those of Stockton and San Bernardino, Calif., pensioners were widely seen as faring better than bondholders since they received smaller reductions to their benefits, though many retirees did make concessions.

Investors are often drawn to municipal bonds, which help pay for public projects, because of their favorable tax treatment: Individuals generally don't pay federal income tax on the interest they receive. And if you live in the state where the bond was issued, the interest may be exempt from state and local income taxes as well.

Given the tax advantages, munis are often associated with investors in the highest tax brackets, but financial advisers said they often made sense for people in upper-middle tax brackets as well, say, 28 percent or higher.

Wherever you fall on the tax hierarchy, however, what has emerged from the financial crises in Puerto Rico and elsewhere are some basic lessons that bear repeating: Invest only in a diversified portfolio of municipal bonds, and know what you own. Financial advisers said it might be hard to assemble a diversified portfolio of individual bonds without $500,000 to $750,000, though some said it could be done with as little as $250,000.

Many mutual funds offer far more diversification: In Vanguard's national municipal bond funds, for instance, most issuers account for less than 1 percent of a fund's overall holdings.

But that doesn't mean fund investors are fully protected, either. Puerto Rican debt, for example, shows up in about 52 percent of municipal bond mutual funds, according to Morningstar. Exposures range from less than 1 percent of the fund's assets to nearly half.

Consider the collection of municipal bond funds offered by Oppenheimer Funds that are named after individual states, which are particularly attractive to people living in those states because they do not pay tax on bond income at three levels: federal, state and local.

The Rochester Maryland Municipal Fund, for example, had about 52 percent of its holdings in Maryland bonds as of June 30, while about 48 percent was in Puerto Rico. And the Virginia fund had nearly 40 percent of its holdings in Puerto Rican bonds, according to Oppenheimer's website.

So how does a fund named after one state invest an overwhelming chunk of its assets in another locale?

It is perfectly legal, according to the Securities and Exchange Commission rules about what companies can name their investments. Yes, single-state municipal funds must invest 80 percent of their assets in investments of the named state. But an out-of-state security can be placed in the 80 percent basket if it pays interest exempt from both federal income tax and the tax of the named state — a bar that is cleared by United States territories like Puerto Rico, Guam and the Virgin Islands.

With Puerto Rico, "because of the high yield and because of its triple-exempt tax status, it made it particularly attractive to some firms and managers that run single-state muni funds," said Beth Foos, a senior analyst at Morningstar, who also noted that the single-state fund's investment universe was limited.

Puerto Rico is an unusual case. But that the small island shows up in so many portfolios should serve as a reminder to all municipal investors. "You need to know where your money is going," said Ann Rutledge, a co-founder of the ratings firm R&R Consulting, "and how you are going to get it back."

THE NEW YORK TIMES

By TARA SIEGEL BERNA

JULY 24, 2015

Copyright © 2025 Bond Case Briefs | bondcasebriefs.com