The Risk in Appropriation Bonds.

Not all municipal bonds are created equal. That principle was reinforced this past week, when Puerto Rico failed to fully pay principal and interest on what market participants call “appropriation bonds.”

This type of bond is repaid only if a state legislature or city council earmarks, or appropriates, payments in the budget. Thus, it lacks the stronger legal protections of other municipal bonds. The missed payment occurred after Puerto Rico’s legislature failed to set aside the money.

In the wake of the drama, some investors say they will think twice before buying this form of debt, which is commonly sold by municipalities on the U.S. mainland, too. The bonds are enticing to some public officials because they can be sold without voter approvals needed for other debt. New Jersey, for example, has $30 billion of these securities outstanding, according to Moody’s Investors Service.

“We don’t see the bonds as offering proper compensation in terms of yield, relative to other options in the market,” says Bill Bonawitz, director of municipal research at PNC Capital Advisors, which oversees $6.5 billion in munis and has generally been avoiding appropriation bonds. “You may be at greater risk than you realize.”

Not all Puerto Rico bondholders are getting stiffed. On July 1, Puerto Rico paid in full what was due on its general-obligation bonds. These bonds, which make up much of the $3.7 trillion muni bond market, are considered to be backed by a municipality’s “full faith and credit” pledge—a promise to pay investors with available revenues, and potentially raise taxes or cut expenditures if there’s a shortfall.

Appropriation bonds do not carry the same pledge. In a prospectus for the Puerto Rico bonds, sold by the Puerto Rico Public Finance Corp., investors were warned in boldface type that the legislature is “not legally bound to appropriate” enough money to pay bondholders.

For individuals buying bonds on their own, highly rated general-obligation bonds are the way to go, says Michael Johnson, head of research at Gurtin Fixed Income Management, which oversees $9.5 billion. He also suggests paper tied to essential services, such as water and sewer systems, which have dependable revenue streams, regardless of economic conditions. “That gives you less things to worry about,” he observes.

Johnson says his firm is comfortable buying appropriation bonds, but that it consistently reviews municipalities for signs of trouble. The bonds can still have some advantages. They can be used to finance new fire stations, city halls, or other important assets that a municipality could lose if it defaulted. In those situations, keeping current on payments might be a top priority for municipal officials, making a default less likely.

However, Puerto Rico’s governor has said the island’s debt is unaffordable, and it remains to be seen whether its general-obligation bonds also suffer losses.

THERE’S TROUBLE WITH appropriation bonds outside Puerto Rico, too.

Take the Metropolitan Pier and Exposition Authority in Illinois, which sold bonds to finance improvements to Chicago convention center McCormick Place. It said this past week that it couldn’t make its monthly deposit to the bond trustee for a coming debt payment. Illinois, which is facing fiscal challenges of its own, hadn’t passed a budget for the fiscal year, so lawmakers never made the appropriation to allow the authority to make the deposit.

It’s still unlikely the authority will default on actual payments to investors. Lawmakers have time to pass a budget before principal and interest is due in December. The bonds are backed by various taxes, including state sales levies, and there’s enough money in the bank for the monthly deposit. But the situation prompted Standard & Poor’s Ratings Services to slap the bonds with a massive downgrade, from triple-A to triple-B-plus, a move that could hurt the bonds’ market value.

BARRON’S

By MIKE CHERNEY

Aug. 8, 2015 1:41 a.m. ET