Bond Case Briefs

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Muni Investors Face Pension Woes.

The longer the Fed keeps rates low, the worse some city and state pension problems may be. The signals from Detroit and Atlantic City.

There are many reasons to like municipal bonds. They've held up well amid recent market volatility, and at longer maturities they yield more than similarly rated Treasuries—much more on an after-tax basis. Tax-equivalent yields for A-rated 10-year munis are around 4%, compared with just 2.2% for the benchmark Treasury.

Yellen & Co. keep promising to raise rates, but investors who hold munis to maturity don't have to worry about falling prices due to interest-rate risk. They do, however, have to worry about credit risk.

Underfunded state and city pension plans are turning into a bigger headache for muni investors. Pension accounting standards are getting tougher, and rating agencies seem more aggressive about downgrades. Lower investment returns this year for pensions will make funding woes look worse. States are trying to bring funding in line with obligations, but changing benefits to current and former employees have been met with stiff legal challenges.

"Investors should be concerned," says Vikram Rai, Citigroup's municipal strategist. "It's a chronic problem for many cities and states, and it's going to take a long time to fix. But rating agencies seem to want a quick fix, which is just not possible."

IF THE FED LEAVES RATES lower for longer, pension-fund growth projections will be harder to meet. Veteran bond investor Bill Gross of Janus Capital urged the Fed to raise rates in his October outlook, writing, "Do central bankers not observe that Detroit, Puerto Rico, and soon Chicago, Illinois cannot meet their promised liabilities?"

Ironically, the pension-funding picture is actually improving for most states, a new report from Loop Capital finds. But the troubled states have grown worse. Loop found the aggregate nationwide funded level dipped slightly from 73.1% to 72.6% in the past year. States including Illinois, Alaska, Kentucky, and Connecticut are funded near 50%. New Jersey is at 39%, finds Loop. "There's been a divergence," says Chris Mier, managing director at Loop Capital. "The gap between the best and worst states is widening."

In the past week, New Jersey's foundering gambling capital, Atlantic City, deferred pension payments to balance its budget. Chicago is proposing tax hikes to get out of a pension-funding nightmare that started last spring when the Illinois Supreme Court disallowed earlier pension reforms and Moody's downgraded its debt to junk.

Chicago shows the danger of a downgrade is real. Not only do bonds fall in value, but a downgrade can trigger escalating financial woes. Short-term debt may come immediately due, and institutional holders may be obligated to sell.

In the worst case, downgrades can lead to bankruptcy, still quite rare for municipalities. But in Detroit, bondholders were required by the court to share the pain, taking haircuts on their debt in restructuring—even in general-obligation bonds, which were once considered inviolable. “Detroit set a dangerous precedent,” says Hugh McGuirk, who heads T. Rowe Price’s muni-bond team. One lesson: “You don’t want to be in lower-quality GOs if this comes to a head,” he says. He prefers revenue bonds that fund airports and hospitals. Generally, their employees have fully funded 401(k) plans instead of pensions.

Choosing a professionally managed mutual fund is one way to handle pension-related risks. At Columbia Threadneedle, analyst Matthew Stephan monitors accounting changes being implemented by the Governmental Accounting Standards Board this year. New guidelines will probably make states underfunding their pensions look worse, but it varies a lot, he says.

For those individuals who want to do their own digging into state finances, the Electronic Municipal Market Access Website (www.emma.msrb.org) is a good place to start.

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