High Yield Municipal Bonds: Understanding Where Credit Risk Lives.

Even among nonrated bonds, defaults are generally rare and focused on narrow areas.

Moody's regularly publishes a study that examines defaults in the rated universe of distressed municipal bonds, but it leaves out a sizable portion of the municipal market that is unrated. To provide clarity on the full municipal market, we conducted our own study using Bloomberg data. Here's what we found.

With over $3.7 trillion municipal bonds currently outstanding, there are approximately $57 billion in municipal bonds (or 1.5% of the outstanding municipal market) in Bloomberg that are coded as distressed. Distressed in this instance can mean that the issuer fully defaulted on a bond payment, partially defaulted on a bond payment, or is in violation of a covenant (i.e., the debt service coverage ratio is below the set-forth amount).

As the table below indicates, the sector with the largest number of distressed bonds is Tobacco, with $14.2 billion or 23.5% of the total. Such bonds are funded with settlement money and categorized as distressed due to the overall decline in smoking and the fact that some large issuers have drawn on their liquidity reserve funds to pay interest. General Obligation (GO) bonds account for $13 billion or 21.6% of the total. This should not be taken as an indication of poor credit quality in GOs overall; it's more that names that have received extensive headline coverage for fiscal concerns-Puerto Rico, Detroit and Jefferson County-all have bonds in the category. The Power sector, the third largest ($8.2 billion or 13.6%), is largely composed of Puerto Rico Electric Power Authority (PREPA) debt, which is subject to similar pressures as other municipal issuance from the commonwealth.

Sector	Par Outstanding	Number of Distressed Credits
Tobacco Settlement	14,240,689,199	40
General Obligation	13,061,406,880	375
Power	8,199,925,000	244
Other*	8,140,559,192	894
Development	4,509,884,983	543
Water	2,324,284,636	212
Pollution	1,427,215,000	46
Facilities	1,292,044,000	191
Nursing Homes	1,192,993,593	311
Medical	1,038,405,000	232
Multifamily Housing	1,000,142,118	195
Airport	830,615,000	19
Transportation	755,055,441	64
Build America Bonds	681,670,000	6
Education	445,625,000	79

Higher Education	350,010,000	53
Utilities	341,515,000	42
Mello-Roos	292,915,000	126
Housing	237,733,785	29
Single Family Housing	62,504,423	32
School District	7,880,000	10
Bond Bank	195,000	1
Total	**$60,433,268,251**	**3,744**

*Other refers to Special Tax District, Bonds, Tax Increment Bonds and certain Community Development District bonds.
Source: Bloomberg, Neuberger Berman, data as of November 23, 2015.

By definition, high yield municipal bonds carry greater credit risk than their investment grade municipal counterparts. But it bears noting that distressed credits are less common among high yield municipals than their corporate high yield counterparts, where 2.3% of bonds are considered to be distressed. 1 As such, we believe that the municipal market continues to be a good place to add credit risk in exchange for additional yield, particularly among what we would characterize as quality non-investment grade issues. Of course, when investing in higher yield bonds, it is important that investors undertake careful analysis of issuer credit fundamentals as they pertain to long-term payment prospects.

1 As defined by the Merrill Lynch U.S. High Yield Index.

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