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Beware Of Pension Obligation Bonds.

These three little letters—POB—can be a pox on your portfolio if you own them or were pressured into buying them. Pension Obligation Bonds do not belong in your portfolio. The reasons are simple. These taxable municipal bonds are issued by state or local governments for payment of obligation to their employee pension fund. Issuing such bonds allow the state or local government that cannot make its payments to the pension fund to borrow the money, then invest it in the stock, bond, private equity or real estate markets. A gamble if there ever was one.

What happens when, like in 2015, stocks and U.S. Treasurys have flat returns? Or, also as happened last year, when investment grade and high yield corporate bonds returned little or (gasp) suffered losses? It's a disaster. Sometimes returns from the POB issuance are below the interest rate the issuer paid to borrow the money. Then, the pension shortfall is actually increased. POBs are a gambler's substitute for not making the required pension contribution with current tax revenues. Sure, the returns can be smoothed out over time. But the biggest offenders have the largest unfunded liabilities.

Some of the most chronically underfunded state pensions are: Illinois, Connecticut, Kentucky, Kansas, Alaska, New Hampshire, Mississippi, Louisiana, Hawaii and Massachusetts.

Then there are city offenders like Chicago, whose pension liabilities are stacking up rapidly causing the city's tax-free municipal bond rating to fall into the junk pile. Any way you look at unfunded pensions and their Pension Obligation Bonds, it's a toxic situation.

If you are seeking taxable income and want to stay away from corporate bonds, here are two taxable munis with good credit metrics, no unfunded pension problems and decent liquidity.

Dignity Health is a health care provider in California. Its services include urgent care, surgery, home health, lab and wound healing care. Dignity Health is a well run not-for-profit corporation whose revenues have exceeded expenses in this most challenging ObamaCare environment. The 3.125% coupon bonds maturing November 1, 2022 at par yield 3.125% to maturity. Bonds are non-callable and rated A3 by Moody's. Its CUSIP is 254010AA9 and bonds should be carefully shopped for.

Another taxable municipal that won't cause pension angst is Virginia Housing Development Authority Rental Housing Bonds. The title is a mouthful but in short: The VHDA's mission is to finance affordable housing for Virginia residents. Rated AA+ by Standard & Poor's, this experienced management team has overseen $8 billion in assets, increased net income in 2014 by 48% from 2013 according to S&P, increased their return on assets and continues to be profitable.

As with all taxable municipal bonds, investors are not exposed to dollar gyrations, China's on again, off again economy, or geopolitical events.

Buy Virginia State Housing Development Authority Taxable Rental Housing Series C, 3% coupon maturing August 1, 2024 at roughly 99.75 for 3.03% yield to worst call and maturity. The CUSIP is 92812Q229. Do not pay much of a premium due to prepayments and the Authority's special redemption rights.

With corporate downgrades and defaults expected to increase in 2016, taxable municipal bonds are a good substitute as long as they are not Pension Obligation bonds.

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