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Municipal Bond Defaults Shake Up a Once-Sedate Market.

Municipal bond issuers have been in the news in recent years for all the wrong reasons, starting with places like Jefferson County, Ala., and Stockton, Calif., defaulting on their municipal bonds. Then Detroit filed for bankruptcy, with $18 billion in debt on its books.

And there's Puerto Rico, which is struggling to make its bond payments — or decide which of its $72 billion in municipal bonds to default on.

Still, money has continued to flow into municipal bonds, a market dominated by individual investors. There have been 27 straight weeks of inflows into municipal bond funds, according to Dan Heckman, senior fixed income strategist with U.S. Bank wealth management.

The main reason for municipal bonds' continued strength is that the interest paid on municipal bonds is free of federal and state taxes, which can exceed 50 percent for top earners in states like New York and California. Those savings give the bonds a substantial advantage over Treasury bonds with similar yields and even higher-yielding corporate bonds.

Still, selecting municipal bonds is not as simple as it was before the spate of defaults changed what was generally a stodgy asset class.

"The municipal bond market has transformed from what used to be a rates market like Treasuries to a true credit market like the corporate world," said John Bonnell, a portfolio manager at USAA.

"It used to be a given that if the issuers had the ability to pay their debt, they would," he said. "Now, it's their willingness to pay that's become more of a focus. Some of these issuers end up with budget situations where they have to pick and choose who's going to get paid what."

Before the financial crisis of 2008 and several high-profile defaults, municipal bond investors relied more on the rating of the bonds, something that an issuer could improve by buying insurance on them.

"What mattered was underlying credit quality and the issuer, but it got obscured for a long time by municipal bond insurance," said John Bussel, chief investment officer of Hewins Financial Advisors, which manages $4 billion for wealthy investors.

"Shakier issuers would buy municipal bond insurance to get them a AAA rating," Mr. Bussel said. "When people were buying muni bonds from a broker, he would say they're AAA insured."

When the crisis came, the solvency of municipal bond insurers was tested, since they had also branched out into insuring the bonds created out of mortgages. While about 55 percent of municipal bonds had insurance in 2008, that number is around 6 percent today. And the number of insurers has dwindled to three from seven.

Mr. Bonnell at USAA said he would rather have no bond insurance, "because we're doing the work," adding, "I'd prefer the issuers didn't pay for the insurance and I'd have the extra yield."

At the moment, shorter-duration municipal bonds are more in favor than longer-duration bonds, even when they pay a quarter of what the longer ones do, because interest rates are expected to rise and the shorter term all but guarantees investors will be paid back.

“Six months to one-year munis have become a bigger part of the market,” said Kimberly Foss, founder of Empyrion Wealth Management. “Today, it’s about high-quality municipalities that will be able to pay the duration of the bond and give people the income they need. What’s left in their pocket after taxes is the most important thing for them.”

With longer-duration municipal bonds, the concern is that an increase in interest rates will erode the value of the investment.

“The biggest risk is with long bonds,” said Todd M. Morgan, chairman of Bel Air Investment Advisors, which manages $3 billion. “Interest rates are unpredictable. They go up 100 basis points,” or 1 percentage point, “and you could lose 20 to 30 percent of your investment.”

As to determining which municipalities will not be able to make their payments for longer-dated bonds, investors can look to the recent past for a lesson — few of the problems cropped up overnight.

“You may get into fiscal difficulties like a Detroit or a Puerto Rico, but those things had a long tail and were running out,” Mr. Heckman of U.S. Bank said. “It shouldn’t have come as any surprise that Detroit ran into financial problems.”

Mr. Bonnell said that investors also needed to bear in mind political changes in the municipalities themselves.

“When it comes to the willingness to pay part, the officials you bought that bond from might be totally different 10 years from now,” he said. “It’s hard to predict with a 30-year bond.”

He added, “If it looks like things are deteriorating and they’re going to have to prioritize, hopefully if you’ve done your work correctly, you’ll be out of it by then.”

The long time horizon shows the value of having someone watch the municipalities, which is something that bond managers do but is also a role played by municipal bond insurers for individual investors.

Natalie R. Cohen, the head of municipal research at Wells Fargo, said that even though the remaining insurers are writing policies on a small number of new bonds, they play a role in negotiations for existing issues “with high-powered legal help in distressed situations, such as Detroit, helping to battle for bondholder recoveries.”

Bill Fallon, chief executive of National Public Finance Guarantee Corporation, a municipal bond insurer, said his firm was doing just that on general obligation bonds from Detroit. He said the holders of the city’s bonds continued to receive interest and principal payments.

While these insurers still have a marketing problem from the financial crisis, Mr. Fallon said that their coverage continued to be needed by smaller municipalities or those that do not regularly sell municipal bonds.

“If a large A-rated municipality is issuing $300 million, institutional buyers will know the issuer and put the resources toward it,” Mr. Fallon said. “Put that against an Iowa school issuance and it’s for $17 million, it’s unlikely you’ll have a large institutional manager putting the staff behind it.”

Brenda Wenning, who manages $22 million in fixed income for 30 clients, said that if her clients bought municipal bonds with insurance, it was generally for longer-dated bonds and for municipalities where they lacked the time or knowledge to do the analysis.

“Buying insured bonds removes having to understand each bond’s creditworthiness and allows the client to sleep at night,” she said.

For people buying municipal bonds on the secondary market, the more general risk comes from the lack of transparency on what the dealers paid for a bond and what they are selling it for.

“Most of the transactions in the secondary market are conducted through a broker or a discount broker, and the individual investor doesn’t have the horsepower or tools for price discovery,” Mr. Heckman said.

The Municipal Securities Rulemaking Board has started a website, called Electronic Municipal Market Access, to help investors track the buy and sell prices on municipal bonds.

But in the end, what matters now is understanding the bond issuers more deeply. “Credit analysis is important,” said Mr. Bussel at Hewins Financial Advisors, “and it’s hard to do credit analysis on muni bonds.”

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