Bond Case Briefs

Municipal Finance Law Since 1971

The Case for Favoring Revenue Bonds Over General Obligation Bonds.

General obligation bonds have encountered problems as municipal issuers face rising fixed legacy costs that challenge revenue growth

A municipal bond is a municipal bond is a municipal bond. Anyone who believes that to be true has failed to see the increasingly idiosyncratic nature of the municipal marketplace.

A testament to that fact: The Barclays Puerto Rico Index declined 12% in 2015, and nothing else followed suit. Muni investors were wise not to draw conclusions about the broader market based on the unique case of Puerto Rico.

The need to be discerning doesn't stop at credit ratings. In fact, it's important to be selective even among traditionally high-quality credits. Currently, there is a strong case to be made for favoring revenue bonds over general obligation bonds.

GO bonds, which today make up one-third of the investible muni market, historically have been considered among the safest forms of municipal debt. Repayment of GOs is secured by a constitutionally prescribed "general obligation" or "full faith and credit" pledge. GOs are paid out of tax revenues and are deemed to have first priority of payment. But municipalities also must use their tax revenues to cover onerous operating costs, and that can leave less money available to pay debt service.

In the past, the security of the GO pledge was rarely questioned. More recently, however, GOs have encountered problems as municipal issuers face rising fixed legacy costs that are challenging or outpacing revenue growth.

Detroit was the first to call into question the sanctity of the GO pledge. As the city took steps to negotiate its way out of Chapter 9 bankruptcy, the repayment of GO debt became a question of willingness, rather than ability, to pay. The question was raised again in discussions in Puerto Rico. There, GOs' constitutional priority had given bondholders confidence in their legal remedies should the commonwealth default. That sense of safety was compromised when a preliminary restructuring plan last year indicated "sacrifice" was needed from all creditors, including holders of GO bonds.

The market has now started to infer potential implications for GO debt in stressed locales such as New Jersey, Illinois and Chicago. While these issuers could raise taxes to meet their debt obligations, such moves are always politically difficult, unpopular and therefore, not easy to implement. The question becomes not whether these stressed locales are able to make the necessary decisions, arrangements and concessions to pay their GO debt, but rather: Are they willing to do what's necessary? Willingness is much harder to read and analyze than ability, and that means GO bonds have been and may continue to be volatile.

Revenue bonds, on the other hand, are underpinned by a dedicated revenue stream, which essentially eliminates any question around a municipality's willingness to pay. Monies generated are specifically assigned to pay debt service. The most common types of revenue bonds are essential-service, revenue-generating projects such as toll roads, airports and water and sewer systems, where the money made (via tolls, fees, etc.) is used to repay bondholders. Revenue bonds are not backed by a full faith and credit pledge, but issuers have the ability to increase user rates should the dedicated revenue stream fall short, and traditionally they have done so to ensure full debt payments.

Not only are revenue bonds showing lower volatility than GOs, but at two-thirds of the investible municipal universe, they represent the largest subset of the market. This means ample opportunity for investors. The health care and transportation sectors, in particular, present some attractive income and return possibilities — the former underpinned by Affordable Care Act-induced demand, demographically driven health care needs and merger-and-acquisition activity, and the latter supported by lower gas prices and increased travel.

Looking to the opposite end of the credit quality spectrum, high yield remains another high-potential area of the municipal market. The sector has produced strong results, tobacco in particular, and is outperforming the broad market year-to-date — notwithstanding Puerto Rico. High yield represents an important source of carried interest and, therefore, income.

Municipal high yield is distinctly different from the corporate high yield market. The two, in fact, have been shown to be uncorrelated. In 2015, for example, collapsing energy prices weighed on corporate high yield and contributed to rising defaults. The Morningstar taxable high yield bond fund category lost 4%, while the high yield municipal fund category was up by slightly more than 4%.

Overall, creditworthiness in the broad municipal space is stronger than at any time since the financial crisis. The market also appears well positioned to continue the solid performance it exhibited in 2015 and so far in 2016. But investors should pick their places, conduct diligent credit research and seek to make the most of all the municipal bond market has to offer.

Investment News

By Peter Hayes

Jun 13, 2016 @ 10:52 am

Peter Hayes is head of the municipal bonds group at BlackRock Inc.