Bond Case Briefs

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How Investors Can Evaluate Muni Bonds in the COVID-19 Economy.

Investors and their advisors need to be extremely thorough in the current environment. Technology can help.

With more than 85,000 issuers and approximately 3 million CUSIPs, the municipal bond market can be challenging to navigate in even the calmest economic conditions. At a time like this, when the COVID-19 pandemic has caused severe disruption, volatility and uncertainty, investors and the financial advisors who serve them need to be extremely thorough when evaluating municipal bonds to add to their portfolios.

Looking Into Issuers & Pledges

Bonds can be repaid from many different sources including property taxes, sales taxes, hotel bed taxes, personal income taxes, mortgage revenues, lease payments for use and occupancy of long-lived government assets, and fees for services such as water and sewer.

These repayment sources can come from leases, essential services like water or electricity, or taxes, such as a state sales tax. General obligation bonds (GOs) have stronger protection measures in place for bondholders because they are backed by the full faith and credit of the issuer to tax state or municipality residents to raise money as necessary to pay the debt. Conversely, revenue bonds are backed by pledges of revenue from specific projects, such as hospitals, universities, bridges and toll roads.

All other things being equal, unlimited tax GOs or essential service revenues like water and sewer are generally safer investments. Investors should note that some general obligation bonds can have statutory limitations on their taxing powers, such as a cap on property taxes or the ability to resolve historical delinquencies. Essential service revenue bonds can be subject to dilution of a bond pledge when additional parity debt is authorized and sold. It is important to understand the effect these limitations can have on the creditworthiness of the bond.

A typical strategy for conservative municipal bond investors is to focus on bonds supported by general obligations or essential services and issued by states or municipalities with AAA ratings. While these are certainly healthy characteristics, advisors and investors should also consider additional factors. For example, how diversified is the economy of the state or municipal issuer? Can it successfully withstand extreme market volatility of the type we are currently witnessing? What is the median income of the people who live there? Are there geographic or environmental risks associated with the issuer? How big is the issuer's market position? (The larger an issuer's market presence, the wider the audience of prospective buyers, giving their bonds a greater liquidity profile.)

Crucially, are the revenue pledges/obligations of the issuer included as a covenant in the investment contract?

These are all prudent questions to ask when vetting possible municipal bond investments.

Duration and Risk

During times like this, when people are concerned not just about the overall economy but also their physical well-being, investors can naturally gravitate towards investments with less volatility. Municipal bonds, like any fixed income security, are exposed to interest rate risk and vary in duration. With a fixed coupon bond, the longer the time until bond maturity, the more susceptible investors are to interest rate changes that will affect the value of their investment.

Laddering the municipal bonds by final maturity within portfolios may help investors with longer investment horizons help reduce interest rate risk. If, for example, an investor has $1 million to invest in municipal bonds, their advisor can work with them to identify a diverse mix of bonds with shorter durations of two to three years, and longer durations of 10 or 15 years.

While interest rate moves don't affect the principal, it does affect the secondary market value if bonds need to be sold prior to maturity. Additionally, a bond ladder is exposed to "opportunity cost" or "reinvestment risk" — the capability to reinvest the principal when it comes due at the same or higher interest rate.

By constructing a portfolio composed of municipal bonds with different durations, investors can arrange maturities as they need their original investment returned and mitigate some duration risk.

How Technology Solutions Can Help Muni Bond Investors

The size of the municipal bond universe, and scale of recent market volatility and uncertainty, can make investment selection and management difficult for advisors and investors. Fortunately for them, modern technological innovations can simplify the process significantly.

By partnering with a fintech provider whose fixed income solutions can filter municipal bonds by type of infrastructure (energy, roads, airports, etc.), obligations and pledges, and more, advisors and investors can view a streamlined list of safe and well-priced bonds at their fingertips via electronic alerts. Advisors and investors should also check to see that any fintech vendor they use can compare bonds from different market sources in order to identify the best-priced securities.

When a fixed income investment platform provider combines technology innovation with a team of experienced capital markets professionals, the vendor can help advisors and investors access, and sift through, past official statements or continuing disclosures from issuers — a vital service for determining an issuer's creditworthiness before investing, and ensuring obligations are covenants in underlying investment contracts. This combination also allows advisors to thoroughly document the process for achieving best execution on every trade.

As long as investors and their advisors have the right mixture of strong market expertise, robust due diligence methodology and innovative technology, they can harness many promising opportunities in the municipal bond market — and utilize these investments to help them navigate the extreme volatility and uncertainty stemming from the COVID-19 pandemic.

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