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Future Returns: Insured Munis Offer Stable Income and Peace of Mind

Investors have had plenty to worry about in 2020, and this is particularly true for anyone who counts on municipal bonds to generate stable and, in many cases, tax-free income for their portfolios.

Covid-19 has put pressure on a wide range of municipal bond issuers, from state and local governments, to universities, senior housing facilities, and convention centers. While there has been an uptick in defaults, it's a long way from the doomsday scenarios that made headlines early this year.

For one thing, the initial analysis of muni defaults was done at the height of Covid-19 shutdowns in March, say Bob DiMella and John Loffredo, co-heads and co-chief investment officers of MacKay Municipal Managers. Meanwhile, not every segment of the market has been squeezed. Public utilities have held up well, while public schools should benefit from continued strength in the housing market. Pension plans, meanwhile, have gotten a lift from the surging stock market.

Still, for many investors—especially those who buy and hold individual bonds—municipal bonds with an insurance wrapper may be worth a closer look.

"It's a bond with a belt and suspenders," DiMella says. "You've got the underlying credit, plus you've got this financial guarantor as a second backstop."

Bond Insurance Makes a Comeback

As the name suggests, bond insurance guarantees that principal and interest for a municipal bond will be paid in the event that the issuer defaults. Such insurance was widely used before the financial crisis, DiMella says, when a handful of companies insured roughly 60% of all new issues in the municipal bond market.

"It basically fell off a cliff after the crisis, with insurance wrappers representing a small percent of the market," he says.

Insured municipal bonds had seen a slow resurgence over the last couple of years, but the Covid-19 pandemic has spurred new demand, with insured munis now representing about 10% of new muni bonds. More large and high-quality issuers are offering an insurance component on new bonds in order to quell investor angst about rating downgrades and defaults. Two companies, Assured Guaranty and Build America Mutual, insure most bonds today.

"Investors get the benefit of stable ratings, increased liquidity, and less volatility," Loffredo says.

Small Price for Peace of Mind

Insurance, of course, is never free. On average, investors will give up between 10 and 20 basis points (1/10th and 1/20th of a percentage point) of yield for muni bonds wrapped with insurance.

While some investors will balk at this tradeoff, especially in a low-yield environment, buy-and-hold investors may find that it's money well spent.

"You don't have to sacrifice a lot of yield to get the benefit of stable cash flow," says Loffredo, who notes that high-net-worth clients and family offices have shown an increased interest in insured munis as of late.

Still Opportunity for Upside

At the same time municipal bond insurance is an inexpensive option for investors who hold bonds to maturity, active investors may also have the potential for price appreciation.

"We would make the argument that there is a lot more value today than there was at the beginning of the year," DiMella says. "In many cases they're wider than they've been in many years."

When the market first sold off this spring, virtually every segment of the muni market was impacted. Insured munis recovered faster than equivalent bonds, but spreads—the difference in muni yields versus comparable Treasuries—for triple-B-rated insured munis are still higher today than they were at the beginning of this year.

In fact, the spread for the insured index versus 10-year Treasuries began the year at 20 basis points and rapidly widened to 190 basis points during the market crisis this spring. They have since narrowed to 99 basis points, but the gap is still higher today than before the crisis, suggesting that yields should come down—and bond prices should move up.

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