Municipal Market Comments

ASCENT Investment Partners

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Muni Armageddon? SEC's Warning Raises Valid, But Manageable, Issues for Investors

On April 16, during a Securities and Exchange Commission-sponsored roundtable discussion of fixed income markets, SEC Commissioner Daniel Gallagher stated that a perfect storm is brewing in the muni bond market that could lead to "Armageddon" for municipal investors. Gallagher noted that an expected rise in interest rates combined with an increasing risk of municipal defaults could lead to massive losses for retail investors.

Commissioner Gallagher's statements have received a good deal of attention in the fixed income markets. In follow-up interviews, Gallagher clarified his statements somewhat, noting that:

- His comments were meant to raise awareness among retail investors in municipal bonds, who he believes may not understand the risks they are taking in the market
- Credit risk in municipals is rising, as evidenced by the cases of bankrupt California cities
- The value of investors' municipal holdings will "plunge" as rates rise, and retail investors will be forced to take substantial losses when they try to sell holdings in a rising-rate market
- Investors are focusing on maximizing yield without understanding the investment risk that they are taking

Ultimately, Gallagher stated that he is not "trying to get people to run for the exits. I just want them to be educated about this." We strongly agree with the Commissioner that investors (whether in munis or any other asset class) should have an adequate understanding of what they are investing in. Investing in municipal bonds can involve a substantial amount of potential interest rate risk, credit risk and market risk. However, those risks can also be effectively managed by educated investors and experienced managers. Below, we outline our perspective on the main points raised by Commissioner Gallagher, and subsequently in the business press.

1. Institutional investors, a.k.a "the Smart Money," typically shun muni bonds. According to the SEC, investors have $3.7 trillion in the muni market and 74% of that money came from retail investors.

Gallagher and others imply that the municipal market is dominated by retail investors because they are too unsophisticated to understand the risks involved, whereas institutions avoid this market sector because they better understand its risks. This statement miscasts the issue as one of unsophisticated investors being duped into a dangerous asset class. Retail investors' access to timely and accurate market pricing data and trade execution is a financial markets issue that is in no way limited to the municipal bond market, or even broader fixed income markets.

The single most important reason that the municipal market is dominated by individual investors is because those are the taxpayers that stand to benefit most from the exemption of municipal interest from federal and in some cases state and local income taxes.

It is true that retail investors are the dominant segment of the municipal buying public, however, it is important to place that statement in context. The SEC figures on holdings come from the quarterly Fed flow of funds data that count retail investors as the ultimate holders of all of the bonds held in mutual funds, money market funds and ETFs. In fact, institutional buyers dominate the marketplace. Though the beneficial owners are ultimately individual investors, funds are managed by professional investors and those funds' investing activities are the main driving force in daily trading in the municipal market. The SEC numbers also do not track international investors, so do not count the fact that the majority of taxable municipal bonds, especially BABs, are reportedly held by international banks and investment companies located outside the U.S.

2. Municipal credit quality is weakening, according to Moody's, Meredith Whitney and others. California cities' bankruptcy woes illustrate this rising problem. According to Moody's Investors Service, muni bond downgrades have outnumbered upgrades for 16 consecutive quarters, which is the longest period that has occurred since Moody's began tracking data.

According to S&P, as of Dec. 31, 2012, 40.67% of all of its U.S. public finance ratings were AA- or higher. The agency goes on to say "widely publicized discussions about credit quality notwithstanding, the actual degree of credit quality erosion in public finance during the year was minimal. Overall, the sector remains significantly stable in nature and sound in credit quality."

Municipal credit quality lags the national or regional economic cycle by one to three years, and rating adjustments can lag another year or two (or more). Municipalities typically derive a significant portion of their revenues from income taxes and property taxes. Income taxes are paid the year after they are earned, so earnings effects from increasing unemployment fall into subsequent tax years. Likewise, many jurisdictions reassess property every two or three years, so declining market values in real estate do not impact tax revenues until the tax year following the next reassessment. Ratings then adjust as municipalities report operating and financial information, which can lag the end of the fiscal year by anywhere from six months to 18 months, depending on the state.

We have just come through the worst economic downturn since the Great Depression and the recovery is advancing very slowly. Municipal governments began seeing revenue impacts in 2009 and 2010, and are only now beginning to see the stabilization of the property tax base and gradual increases in sales and income tax revenues. Of course there have been more downgrades than upgrades for an extended period. The financial crisis and Great Recession bankrupted two of the Big 3 carmakers, most of the world's banks and brokerages (though most were "TARPed" before they had to file) and countless other companies big and small. The fact that since 2008 only 21 rated municipal issuers have defaulted on bonds (and the great majority of those were BBB hospitals or project financings) is a testament to the great credit strength of the muni market as a whole.

3. Any exit strategy from the muni bond market, when interest rates rise, will be very expensive and incredibly difficult. Unlike other bonds that are much more liquid – think US Treasuries or high-grade corporate debt – the municipal bond market operates under rules that are pretty much, "You buy it, you own it, good luck getting rid of it."

Municipal bonds are a very inefficient trading vehicle, and we would never recommend that a muni investor buy them as part of a trading strategy. Municipal bonds are appropriate as part of a core fixed income portfolio that should be designed to be held to maturity. If bonds pay as scheduled (and proper credit selection and monitoring ensures that they will), investors will be paid par at maturity. Bonds should not be sold at a loss in a rising rate environment – provided their credit quality remains strong – any more than they should be sold at a premium when rates decline to "capture the gain."

It is true that low-rated municipal bonds are relatively illiquid. But also note that the author is trying to compare weakening credit muni bonds with Treasuries or high-grade corporates. An apples-to-apples comparison of high-grade munis to high-grade corporates shows that while munis are somewhat less liquid than corporate bonds or US government securities, investors are compensated at purchase for that liquidity risk through higher after-tax yields.

4. With interest rates at record lows, investors are seeking return and income from an ever-riskier pool of investments. ...The fear is that investors may not have been told by their brokers about the "interest rate" risk and the "wipeout" risk should more municipalities file for bankruptcy, as many have already.

There is no such thing as a free lunch. Investors that chase yield in a low rate market can do so only in a few ways – buy lower credit quality (credit risk), extend maturity out the yield curve (interest rate risk) or accept more limited liquidity (market risk). It is true that many investors buy portfolios of very long maturity bonds of lower credit quality to capture the maximum available yield in this type of rate environment. By doing so, they take on a tremendous amount of market and rate risk, as those bonds will perform poorly in a rising rate environment.

Ascent's approach to investing in a low rate environment is to ensure preservation of capital while achieving a competitive rate of return. We do this by limiting interest rate risk by closely managing the duration of the portfolio to protect against rising rates. We also do this through rigorous credit selection that not only avoids issuers with deteriorating credit trends, but also monitors those holdings to ensure that if signs of weakening do become evident, we can reposition the portfolio before there is a credit problem. By investing only in highly-rated bonds, we maintain the maximum liquidity available in the municipal market.

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