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Muni bonds in a complex marketplace

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Municipal bonds can help provide diversification and attractive performance within the fixed-income allocation of a portfolio. However, the universe of municipal bonds is large, complex, and the market can be inefficient. Choosing an experienced portfolio manager may help you make the most of this diverse and dynamic asset class.

Key points

- At the state level, municipal finances are generally improving, although some outliers remain.
- Historically, in a rising rate environment, municipal bonds have tended to outperform Treasuries.
- Municipal bonds are sold in a complex and inefficient marketplace.

The Fed has begun to raise short-term rates, however the pace and path of future rate hikes remains uncertain. In the past, when interest rates have been rising, municipal bonds have typically outperformed Treasuries of a similar maturity. Given the current rising rate environment, many investors are reviewing fixed income allocations within their portfolios, including those allocations to municipal bonds, with an eye towards improving diversification and enhancing total return.

Current credit environment

The National Conference of State Legislatures reports that state budgets for fiscal 2015 continued to improve with revenues hitting new peaks in many states. Most states have recovered fairly well from the recession because the bulk of state revenues comes from personal and corporate income and sales taxes, which have been growing. Many states are either setting aside excess revenues in reserves to provide a cushion for the next recession or lowering tax rates.

However, those states heavily involved in the Energy sector, including both the oil-patch and the coal-patch states, are currently facing budget shortfalls related to lower energy-related revenues. The oil-patch states, including Alaska, Louisiana, Oklahoma and South Dakota, have been hard hit by the plunge in oil prices. The coal-patch states, including Kentucky, Pennsylvania, West Virginia and Wyoming, have been hit by reductions in coal usage due to more restrictive air pollution regulations.

Local governments were slower to recover financially but continue to make progress in most parts of the country. State support for local governments has improved in many states, and local governments are now reaping the benefit of their reliance on property-related taxes. Following a significant up-tick in real estate prices in many areas over the past two years, local governments are benefitting from higher property tax revenues. However, pockets of depressed property values remain in some areas throughout the country.

While state and local government finances have improved in many parts of the country, the last few years have seen Detroit going through bankruptcy, Atlantic City teetering on the edge of bankruptcy, and Puerto Rico struggling to restructure its debt to avoid default. Each of these governments experienced long, slow declines which were papered over with debt refinancing and one-time budget gimmicks. And while the recession may have contributed to these governments' problems, it did not cause them. The vast range of differences in the financial condition of the 50 states, as well as the thousands of local governments in the U.S., underscores the need for professional investment advice in the municipal market.

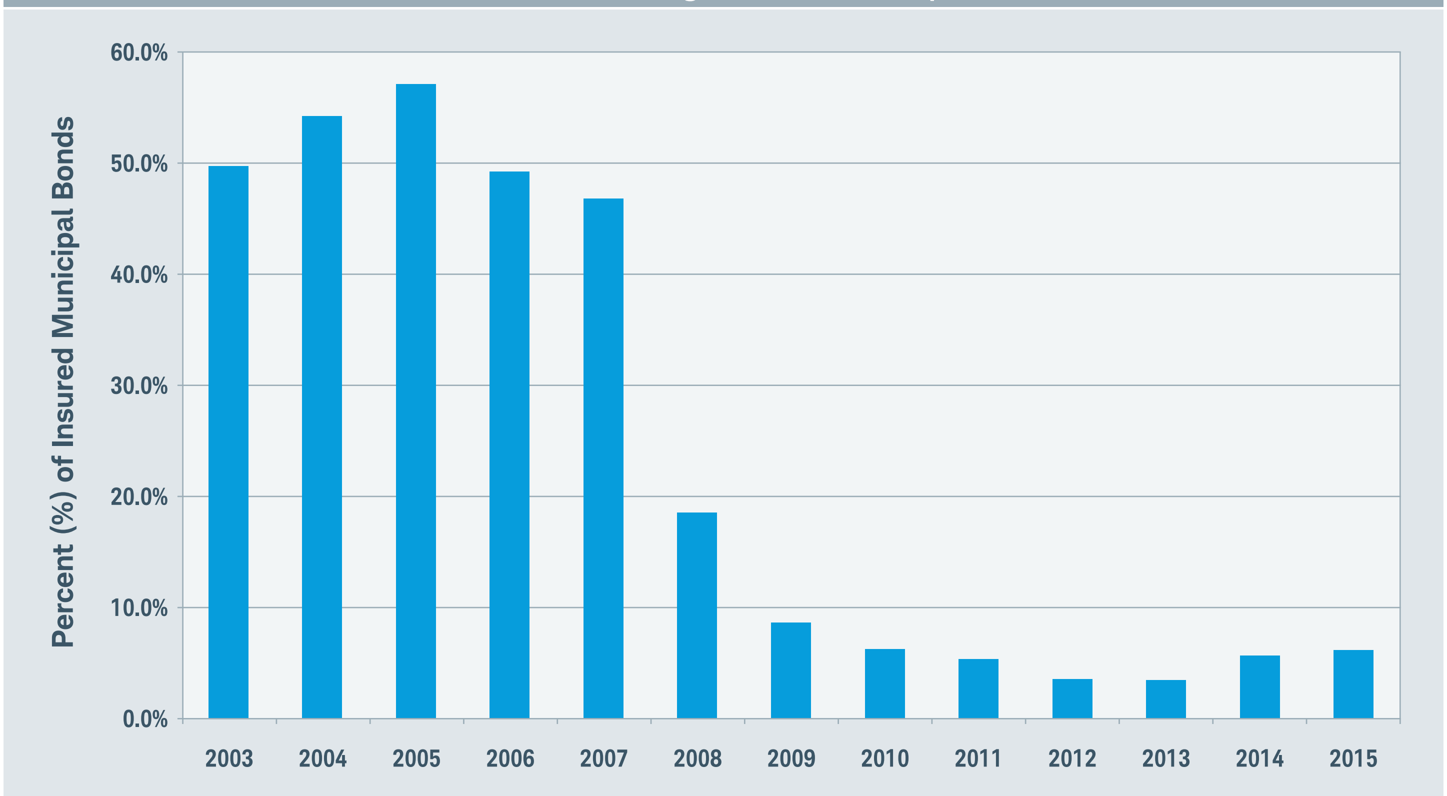
Additional hurdles

State and local government budgets continue to be challenged by future pension and retiree healthcare costs, which may not be readily apparent without close review of a government's financial statements. The potential for these types of financial challenges means that it's important for investors to research each individual bond issue before making investment decisions. Chicago is a good example of a local government that has been severely weakened by financial pressures related to inadequately funded pensions. The city of Chicago's strong, diversified economy is one of the most successful indicators of a local government's health. Years of underfunding its employee pension systems, though, coupled with reliance on reserves, have left the city with substantial unfunded pension obligations, minimal reserves and very low credit ratings.

The value of credit research

Prior to the financial crisis, the market for municipal bonds was much more homogenous, with more than half the new-issue market being insured against default. Today, very few municipal bonds are insured, creating a greater need for active research and careful security selection. Identifying credit risk is an important aspect of successful municipal bond management. While there have been a handful of high-profile municipal bankruptcies, the incidence of municipal bankruptcy is no higher today than its historic average. The likelihood of a municipal bond issuer experiencing financial distress, however, is growing with the increased scrutiny on pension and health care obligations.

U.S. Public Finance Insured Penetration Rate (Percentage of Insured Municipal Bonds)

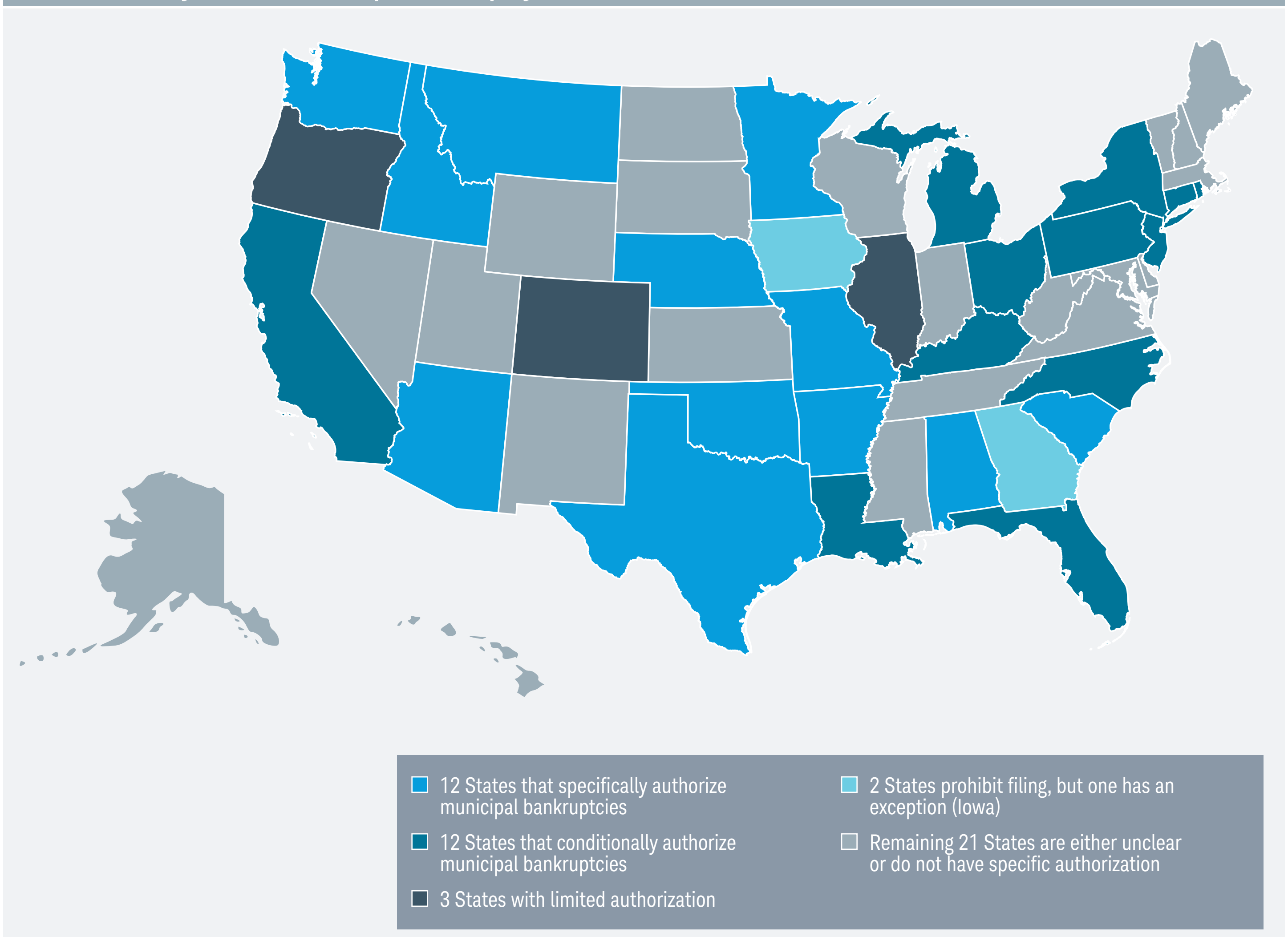


Source: The Bond Buyer and CSIM Credit Research

Municipal bankruptcy

Not all states allow their local governments to file for bankruptcy. In those that do allow it, each bankruptcy proceeds on its own course. In addition, while a Chapter 9 municipal bankruptcy proceeding occurs in federal bankruptcy court, the ultimate settlement may have to take state laws into account. Consequently, what happens in a municipal bankruptcy in California may have little correlation to what may happen in another state, such as Michigan; two states that have recently experienced high-profile municipal bankruptcies.

Authorization by State for Municipal Bankruptcy



Source: © James E Spiotto and Chapman and Cutler LLP. August, 2014

A complex marketplace

Inefficiencies in the municipal bond marketplace may be attributed in part to having a larger number of issuers selling many smaller sized issues than we find in other sectors of the fixed-income market, such as those for corporate or U.S. government debt. In addition, many of the municipal bonds that are sold in the primary market may seldom trade in the secondary market.

There is currently no mechanism for quoting the prices of municipal bonds in the same way that we would expect to see the prices of large-cap stocks quoted throughout the trading day. Instead, prices for municipal bonds are generally determined by an agreement between a buyer and seller. While disclosures have improved in the last few years, the municipal bond marketplace is still opaque.

Adding further complexity to the marketplace, similar municipal bonds can trade very differently, depending on the state of issuance, coupon, call structure, and sector. For example, a bond issued by a city in California may trade at a higher price than a very similar bond issued by a city in Texas, due to differences in state personal income taxes among other factors. California has a high personal income tax rate while Texas does not have any personal income tax, leading to increased demand for California bonds relative to those from Texas.

For an average investor, trying to research more than 50,000 different issuers in 50 different states can be too time-consuming to tackle on their own. Many municipal funds employ full-time credit analysts to assess the market and bond issues in-depth on a daily basis.

Learn more

Municipal bond funds can be a useful part of the fixed income allocation of an investor's portfolio. However, there are also important risks to consider.

Bonds and bond funds are subject to negative price fluctuation during times of increasing interest rates. Bond funds are subject to the risk that a decline in credit quality of a portfolio holding could cause the fund's share price to decline. Fixed income securities are subject to other various important risks that should be considered before making any investments in a bond fund, such as: changes in inflation, market valuations or events, liquidity, prepayments and early redemptions.

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Fixed-income securities are subject to increased loss of principal during periods of rising interest rates. Fixed-income investments are subject to various other risks including changes in credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors.

Diversification strategies do not ensure a profit and do not protect against losses in declining markets.

Investment income may be subject to certain state and local income taxes. Capital gains are not exempt from federal income tax. If certain types of investments the fund buys as tax-exempt are later ruled to be taxable, a portion of the fund's income could be taxable.

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