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Investment Research

A Balanced View of the State of the Municipal Bond Market

BALLENTINE PARTNERS | NOVEMBER 2010

Despite the steady drumbeat of negative press about the state of municipal finance in the United States, we believe the risk to our clients' municipal bond portfolios is extremely low.

State and local governments, feeling the impact of the economic turmoil of the past few years, are currently struggling with significant budget deficits. This has given rise to a number of pundits and financial columnists warning about an impending collapse of the municipal bond market. As the most significant holding in our clients' aggregate investment portfolios, we are understandably concerned about the state of municipal finance in this country.

However, our view is much less dire than the extremist "doom and gloom" authors. We continue to believe that intermediate term, high-quality municipal bonds provide the best solution for high tax-bracket investors looking for principal protection and predictable income. This article provides some additional information supporting our views about municipal bonds that is intended to be a counterbalance to many of the sensationalist articles currently in circulation.

Low Historical Default Rates

The universe of municipal bonds is broad and diverse, covering everything from General Obligation bonds, backed by the full faith and credit of the issuing state, to bonds tied to the revenue of a toll road or hospital. With over 60,000 issuing entities, the range of credit quality available in the municipal market is enormous. Thus, the first key point to remember when reading articles about the state of the municipal bond market is they often have little relevance to our client portfolios. We recommend allocations only to the highest quality portion of the market with the strongest issuers. For example, an article discussing impending problems for nursing home bondholders should not be read with concern, as none of our clients have exposure to these bonds[1].

Defaults for investment grade municipal bonds as an asset class are extraordinarily low by any measure, as evidenced by the following chart:

Municipal & Corporate Default History, 1970 - 2009		
	Moody's	
	Municipals	Corporates
Aaa	0.00%	0.50%
Aa	0.03%	0.54%
A	0.03%	2.05%
Baa	0.16%	4.85%
Investment Grade	0.06%	2.50%

Source: Moody's Investor Services cumulative default rates within 10 years of original issue, by rating category

As the chart shows, while default rates have been miniscule over the past 39 years, there have been 54 municipal defaults. 78% of these municipal defaults in this time frame were healthcare or housing bonds, which are generally lower quality. Defaults in the higher credit quality issuances (Aaa-A), representative of our client portfolios, are even lower. There have only been three General Obligation bond defaults since 1970, out of the tens of thousands issued.

Defaults do not equal losses

A default is a legal condition triggered by a missed bond payment. It is obviously an undesirable financial event and typically indicates the borrower is under financial distress. However, in the municipal world, it is often simply a precursor to a financial restructuring rather than a bankruptcy filing, which is much more common in the corporate environment. For example, the vast majority of investors who owned Orange County, California bonds during their default in 1994 (one of the highest profile defaults in history) eventually recovered 100% of their principal.2

Arkansas, the only state to have ever defaulted on its General Obligation bonds (during the Great Depression), made its bond holders whole shortly thereafter. Of course, the strong preference is to avoid any defaults whatsoever (the reassurance that losses “won’t be too bad” is like hearing “if your plane crashes on water, we have very good lifejackets under the seat”). It is important to remember that the vast majority of municipal defaults result in no eventual loss to the bondholder, so the prior statistics should be viewed with this in mind.

We completely understand that “Don’t worry, it hasn’t happened before!” as a response to why the municipal market won’t collapse is faint comfort and will likely be discounted by many readers. While prior default statistics provide some historical context, the questions “Is it different this time?” or “What could happen?” are important ones.

The markets have just experienced a 24 month period, unprecedented in our lifetime, where the creditworthiness of all types of fixed income securities have been called into question. Even the safety of our own Federal government’s bonds has been viewed skeptically in the financial press. Throughout this period, the municipal market has performed well, providing stability and withstanding the strict scrutiny that market participants have applied to all forms of debt instruments.

Today, the municipal market is strong. Right now, investor appetite is very healthy, as measured as the supply/demand balance in the market. This is one of the reasons why yields are so low on municipal bonds. There is currently more demand (investor appetite) than supply (issuance) and we see that continuing into the future. The emergence of Build America Bonds (a program created by the Obama administration to promote the issuance of taxable municipal bonds to lower the cost of municipal financing) has eliminated a major portion of traditional municipal issuance, causing a considerable shrinkage in supply.

Any increase in the tax rates makes municipal bonds more attractive relative to other asset classes. There is every indication that tax increases on high-income individuals are imminent and considerable.

What could go wrong?

With the municipal bond market performing well and showing little signs of stress, what could change that? What would cause investors to be unwilling to lend to municipalities? The obvious answer is that widespread defaults would shake investor confidence enough to cause demand to come to a screeching halt. Some articles have used the recent examples of Vallejo, California and Harrisburg, Pennsylvania as evidence that “cracks in the dam” are forming.

With 60,000 issuing credits in the municipal market, it is evident that, at any point in time, there will be specific, isolated occurrences of financial distress among some issuers. Vallejo and Harrisburg are two of the most egregious examples of mismanagement and have been well-known problem credits for some time. They are not in the universe of credits that our managers would have considered (as one of our managers said to us during a due diligence meeting last year, “anyone who touches Vallejo with a ten-foot-pole gets what they deserve”).

Defaults in the municipal world are not sudden surprises; they are slow-moving train wrecks that unfold over a significant period of time. We hire bond managers with strong credit research and monitoring teams for exactly this purpose: to keep our clients invested in the highest quality issuers while avoiding the problem names.

For example, current potential problems such as Detroit and New Orleans are simply avoided by our managers. Pointing to examples such Vallejo and Harrisburg as evidence for why not to buy municipals is akin to pointing to Pets.com3 and suggesting you should not invest in the stock market.

However, we do believe the stress on municipal budgets will continue and, as a result an in-depth credit research will become increasingly important. In our view, the days of municipal bond managers offering a commoditized product of “plain vanilla” bond management are gone, probably forever. The focus of our due diligence meetings with existing and potential new managers is determining the skill and depth of their credit team.

Bondholders are protected by a number of safeguards. To amplify on our view of the current state of the market, we need to delve into the arcane world of municipal finance. Municipalities are certainly experiencing a period of fiscal strain, bordering on crisis in some cases. However, it is the leap from that to the conclusion that increased bond defaults are forthcoming, with which we disagree.

A critical fact regarding state budgets, and one often ignored during discussions of municipal finance, is that debt repayment is often legislatively mandated to be very high in the priority of required payments. States must pay bond holders back before they can use collected revenues for most other parts of their budget. For example, in California, the state constitution mandates that “State revenues will first be set apart…[to support]…the public school system and public institutions of higher education.”

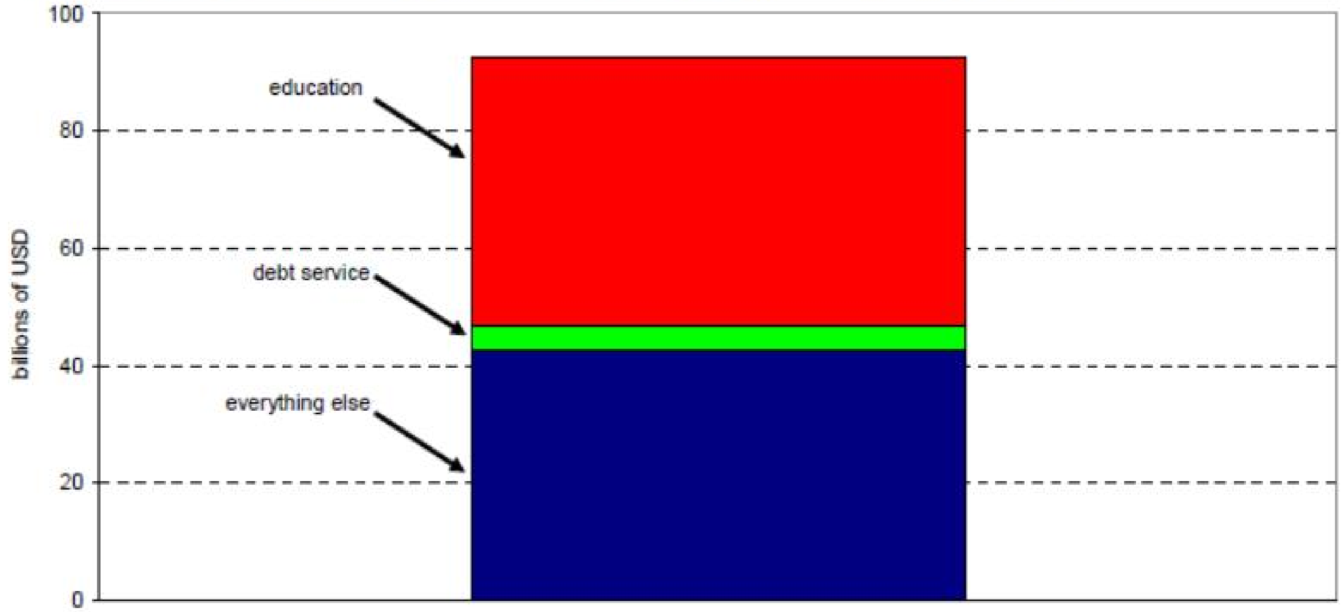
This is the “only provision of the State Constitution that creates a higher priority for any State fiscal obligation” than paying back bond holders.

This chart shows that California spends about half of their budget on education. Next comes payment to their bondholders (the bar in green), followed by everything else. State officials would have to suspend all payments in the “everything else” category before they were constitutionally permitted to suspend debt payments. Revenues would have to drop 45% before bondholders were in jeopardy. As context, the recent market events that created the budget problems in California were driven by a 14% drop in revenues over two years (and next year’s revenues are projected to grow by about 2%). While another major drop would undoubtedly have traumatic implications to the State’s workers, government programs, and fire and police forces, the bondholders would remain well-secured.

A related point from the chart above that readers may have observed from studying the green debt service bar: the annual cost of servicing municipal debt is a fairly modest portion of state budgets; the average is about 4%.

In comparison to the European sovereign debt situation (which some authors have used to draw parallels to

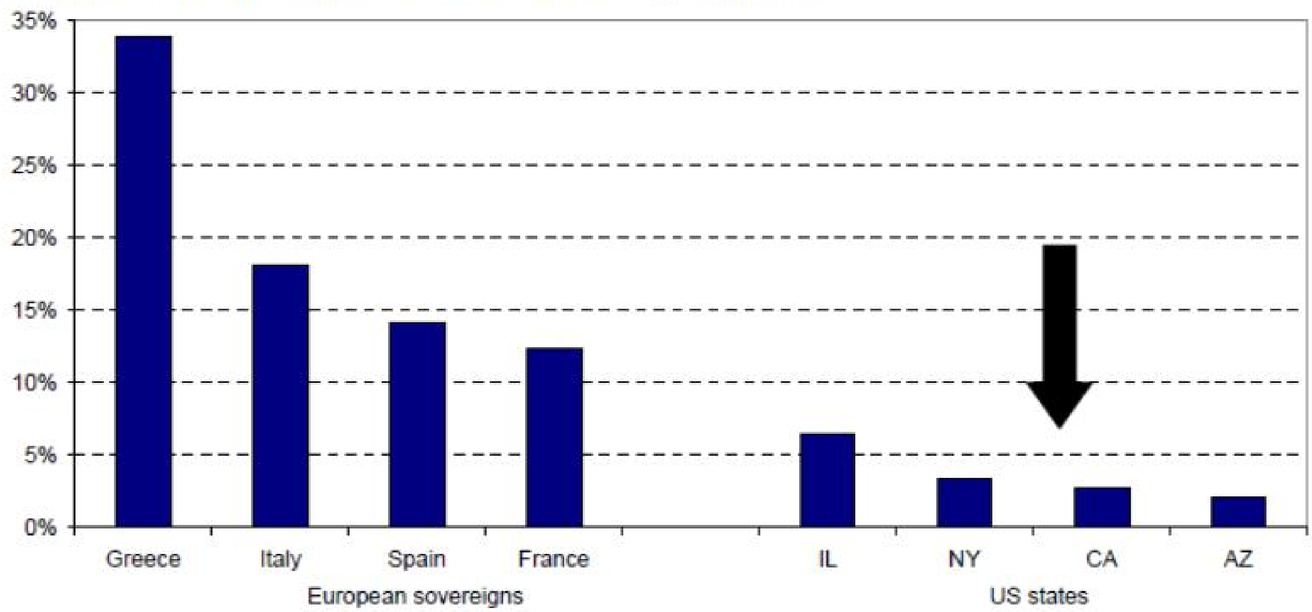
Expenditures from '09 California General Budget Fund (Sorted by Seniority)



Source: State of CA official documents.

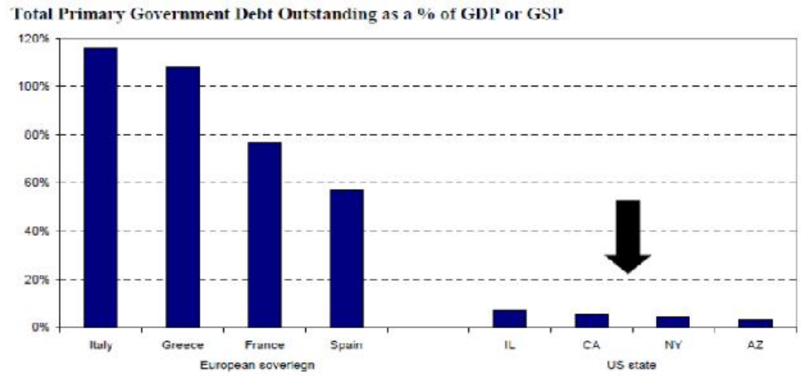
the municipal market), the chart below indicates that debt service as a percent of expenditures is much lower for even the most troubled states than it is for major European countries.

Estimated 2011 Debt Service Cost as a % of '09 Expenditures

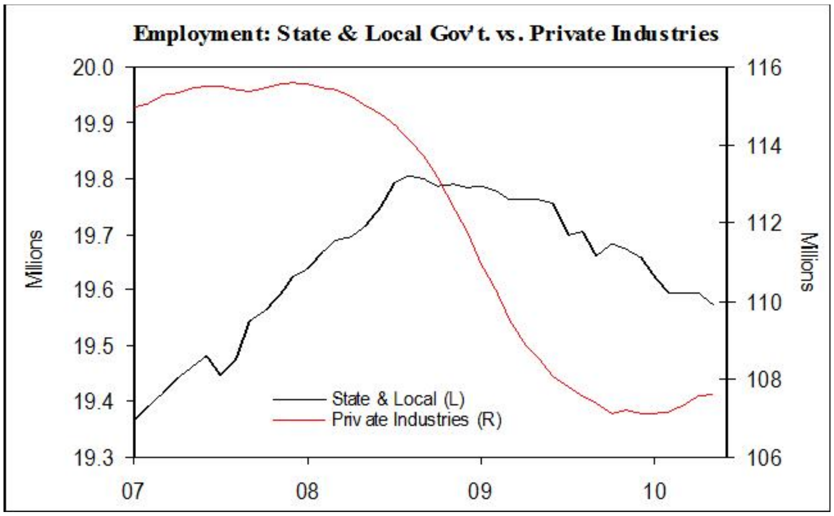


Source: Deutsche Bank, state financial reports.

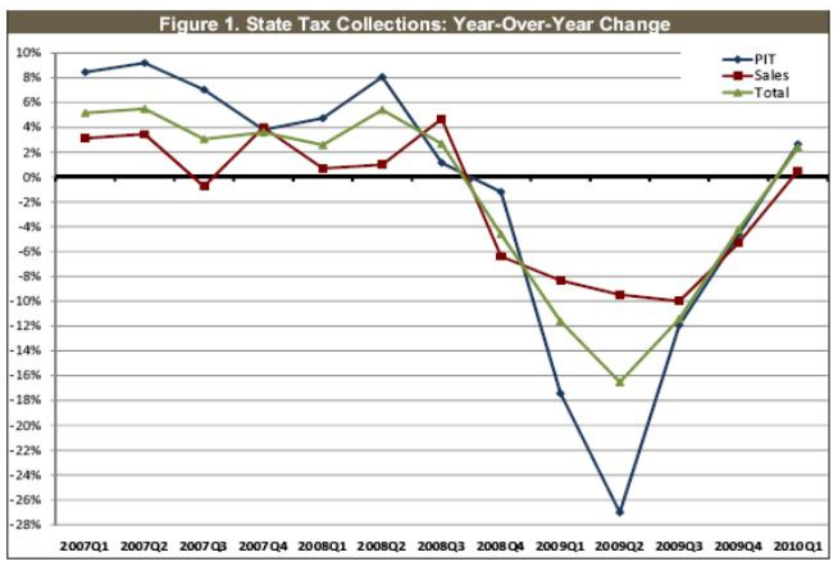
Another way to represent the size of the state outstanding debt is to show the amount as a percent of GSP (Gross State Product). The story told is similar to the previous graph.



Source: Deutsche Bank, state financial reports.



Keep in mind, most states and municipalities are required to enact a balanced budget annually. The multitude of articles appearing during difficult times is a natural result of the political process of discussing spending cuts and tax increases. While this creates much angst and scary headlines, it is actually a healthy mechanism to keep cumulative debt levels low. Needless to say, the Federal government has no such requirement. Below is a chart showing employment levels since 2007:



As you might expect, State and Local governments are not as nimble at responding to the market downturn as private industry, but it is evident that the painful process of belt-tightening has begun. Collections have turned positive again for the first time since Q3 2008:

One final point on municipal finance: a discussion of pension and post-retirement health liabilities. Currently, there are $3 trillion in retirement benefits promised to state and local government workers, and according to the Pew Center on the States, assets are underfunded by $1 trillion. Many municipal “critics” have focused on this point. We agree it is an important issue and it is a problem that needs addressing as it grows, but is not an emergency. We also believe it takes a crisis to make the hard decisions and address the problems in state and local politics. We are at that point now.

Undoubtedly, some hard choices will have to be made. The range of what is possible (for example, retroactive changing of pension benefits) is currently being debated between states and unions across the country, through a variety of legislative and judicial skirmishes.4 As we monitor the situation, it is important to know that this issue isn't borne equally across issuers. Some states are in much better shape than others, with 29 of the 50 states being underfunded by less than 20%. This is another important factor for our managers' credit analysts, and one we are seeing implemented more regularly these days.5 6

Certainly, we expect difficult financial times to continue, which will impact all aspects of our economy and the markets. However, we do not think the high-quality subsector of the municipal market is at risk for significant defaults or losses. Debt burdens are relatively light, and annual required payments are often senior to most other budget items. Municipal bonds play a crucial role in the underlying infrastructure of our country, both financial, in facilitating the functioning of state and local budgets, and physical, in providing funding for our roads, airports, and bridges, for example. We think there are enormous political and economic pressures that will continue to enable the municipal market to function smoothly for the foreseeable future.

References

[1]Municipals such as these are considered "non-essential revenue bonds" and are avoided by our managers. Examples are nursing homes, hospitals, sports stadiums, or other projects where repayment of investor capital is dependent on the success of a particular project, and is not guaranteed by the full faith and credit of the issuing state or town. "Essential service revenue bonds", which are typically included in our clients' Investment Policy Statements, also depend on the revenue of a particular project but one that is monopolistic in nature and is essential to the functioning of the town or state. Examples are water and sewer treatment.

[2]This is one of the three aforementioned General Obligation bond defaults since 1970. The other two are 1988's Baldwin County, Alabama, in which investors recovered 100% of their capital, and Jefferson County, Alabama, a recent default whose outcome is uncertain. Many may also remember New York City's financial woes in the 1970's. However, through a combination of borrowing, cutbacks, and higher taxes, New York did not ever default.

[3]Pets.com was one of the more notorious blow-ups of the dot.com era, raising $82 million at the height of the bubble (February 2000) only to be out of business by the end of the year.

[4]There have been more changes to address pensions in the past year than the previous 7 years combined. For example: Minnesota (reduction of increase for retirees), Colorado (no cost of living increase for 2010), South Dakota (lowered retiree increases), Wyoming (requiring employee payments), Mississippi (increased employee contribution), Connecticut (union concessions), Rhode Island (increased retirement age), and Vermont (increased retirement age).

[5]For example, Breckinridge, one of our recommended bond managers, has stopped buying long-dated Illinois bonds, even GOs ("general obligations" backed by the full faith and credit of the State Government) because of this issue.

[6]For a much more detailed discussion of public sector liabilities, including a historical perspective, impact on municipal quality, and possible solutions, please see http://www.bondinvestor.com/Commentary_February_2010_Special.aspx

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info@ballentinepartners.com
https://ballentinepartners.com

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