FINANCIAL RESOURCES GROUP
A Registered Investment Advisor

Market Insights

January 13, 2010

Municipal Bonds: The Good and the Bad

Not all municipal bonds are the same. The following discusses some things to consider when investing in municipal bonds.

Municipal bonds are commonly thought to be high-quality, low-risk investments. Default studies by the three major municipal bond rating agencies imply that municipal bonds are only second to U.S. Treasuries in terms of timely payment of scheduled principal and interest. Historically, the default rate for all rated municipal bonds has been less than 1 percent and less than one-quarter percent for investment-grade municipal bonds.[1]

Some municipal bond investors may have concerns about the financial health of their municipalities. Common logic would say if property values fall, property taxes will fall as well. Additionally, if retail sales slow down, then sales tax revenue must fall. These two revenue sources help fund projects and activities throughout most towns and cities.

Even if this is the situation, study after study suggests that municipalities usually do whatever it takes to make their interest and principal payments. Most will cut services, close offices and/or lay off employees to adjust expenses to match falling revenue.

However, a thorough sector analysis by Fitch suggests that there are significant differences in credit quality among sectors in the municipal market, even if both carry similar ratings. In fact, defaults by general obligation and essential purpose municipal bonds are especially unusual.

The majority of defaults happen in sectors like multifamily housing bonds, nursing home and retirement facility issues, industrial development bonds and special assessment districts. Investors who avoided these sectors missed most of the default risk in the municipal asset class. For example, Fitch looked at defaults by sector from January 1980–October 2002 and found that while 575 industrial development bonds had defaulted during this time, only four general obligation (unlimited tax) bonds had defaulted.[2]

Interestingly, Fitch also studied whether municipal defaults increase during weak economic periods. They found that there is a "moderate correlation between the percentage change in gross domestic product (GDP) and the dollar volume of defaults that occur in a given year; a one year lag produces a somewhat higher correlation."[3]

The study shows that the historically riskier sectors have the strongest correlation to slowing growth in GDP. Defaults for traditionally safer sectors tend to occur for situations that are "indirectly related to economic conditions."[4] An example of this is Orange County's default in 1994. In this situation, a dramatic adjustment in interest rates severely affected the interest-rate-sensitive (and highly speculative) investments made by Orange County.

In a recent review of the nearly 16,000 unique municipal bonds being offered for sale by Bonddesk.com, all but one of the defaulted bonds were from sectors that do not meet BAM's purchase criteria. The one exception was a general obligation bond that missed one payment in 2004, but didn't initially meet our credit rating and would not have been a bond that we would have purchased.

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We continue to advise buying municipal bonds backed by either the general obligation of a municipality or by an essential revenue source. Additionally, we continue to look beyond credit enhancements/insurance to the actual credit rating of the bond and recommend investing in AAA/AA-rated bonds. These standards have served our clients well.

[1] Brian Tournier, **Municipal Fixed Income Research Report.** *A.G. Edwards*, June 8, 2007.
[2] David Litvack and Mike McDermott, **Municipal Default Risk Revisited.** *Fitch Ratings*, June 23, 2003.
[3] Ibid.
[4] Ibid.

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