

Addressing Heightened Concerns in the Bond Market

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Municipal Bond Overview

Over the last several months, the municipal bond market has come under intense scrutiny as concerns have grown over mounting debt loads and ongoing budget deficits. According to the Center for Budget and Policy Priorities, states are projected to face more than \$100 billion in budget deficits in fiscal year 2012 alone. In addition to short-term budget deficits, states and local municipalities have become increasingly burdened with long-term liabilities tied to pension benefits and healthcare costs. In an effort to seemingly capitalize on investor fears, the media and several prominent figures in the investment community have warned of widespread defaults in the municipal market and massive losses for bondholders. Several reports have compared the current municipal situation to the sub-prime mortgage crisis that led to the recent recession. While these predictions gain a lot of attention and make news headlines, they tend to rely on broad assumptions and rarely, if ever, include any fundamental credit analysis. Consequently, there are a number of misconceptions associated with state and local debt, many of which have led to the heightened level of concern in the municipal bond market.

Although we agree that many states and local municipalities are dealing with economic challenges, we believe fears of widespread defaults and massive losses are likely overblown. Unlike other entities, many state and local governments are legally required to balance their budgets annually, and all have the ability to raise revenues, reduce services, and delay non-essential payments in order to meet their financial obligations. Furthermore, municipalities have limited access to bankruptcy; in fact, it is prohibited in twenty-four states. In addition, the burden of proof regarding insolvency (in order to file for bankruptcy) is extremely high in the remaining states. Historically, this has led to exceptionally low default rates in the municipal bond market. **According to a recent Moody's study, the average municipal default rate from 1970-2009 was 0.09%, and less than 0.03% for securities with a credit rating of A and above.** Not only have default rates been low, but recovery rates have been very high. In fact, some of the largest municipal defaults in history (New York City, Cleveland, and Orange County, California) have resulted in bond holders receiving 100% of their principal and interest payments.

Short-Term Risks

Despite the historically low default rates and the strength of a large number of municipal credits, the financial travails of certain municipalities will likely result in ongoing headline risk, increased volatility, and selling pressure as retail investors continue to pull their money out of municipal bond mutual funds and ETFs. According to the Investment Company Institute, municipal bond mutual funds have seen more than \$40 billion in outflows from the beginning of November 2010 through the end of March 2011.

Within our municipal bond allocations, there are a number of ways in which we attempt to mitigate these short-term risks:

1. Active management
2. Diversification
3. Emphasis on high quality securities (predominantly AAA and AA rated)
4. Reduction of core fixed income exposure as part of the overall tactical asset allocation

Objectives and Expectations – Municipal Bond Allocations

What should investor expectations be for this asset class? At Convergent, we consider the core fixed income allocation to be the ballast of the portfolio—an investor’s primary source of capital preservation. Our primary objectives for our core fixed income allocation are to minimize downside risk and generate a reliable stream of income that may be used to support spending needs. As a result, we seek to minimize credit and interest rate risk to the greatest extent possible by hiring managers with a focus on high quality securities and utilizing short and intermediate maturity strategies.

Some may ask, “Why should I hire any active managers in this category when they have such a difficult time outperforming their benchmarks?” **In our opinion, investors should own a combination of quasi-passive and active managers, but should not expect core municipal bond managers to outperform the broad municipal indices on a net-of-fees basis.** Bond indices have a number of flaws that we believe make them difficult to replicate (that’s why passive bond strategies are not truly passive), and make outperformance unrealistic for active managers:

- Investors cannot replicate an identical portfolio to the index due to the existence of illiquid and untraded securities (i.e., they are not investable).
- The indices don’t take into account transaction costs, which can be a meaningful drag on returns in the bond market.
- If investors mirrored the concentrations in sectors and/or states in many municipal bond indices, they would be taking on far too much credit risk.

Studies have shown that the municipal bond market is very efficient, and the only way to generate excess returns above these poorly constructed benchmarks is to take on additional duration and/or credit risk. Investors should not expect their investment managers to take on additional risk simply in order to outperform the index.

The presence of these issues often skews the returns of the indices and makes them an unfair comparison for investment managers. We believe the proper way to measure performance is to compare investment managers to “index-like” alternatives (i.e., Vanguard) or peer groups. Evaluating managers against their peers provides investors with a much more realistic comparison because it only presents the performance against other investable options.

Conclusion

In summary, the recent recession has certainly had a major impact on the financial condition of most municipalities. While we believe this may lead to an increase in defaults over the next few years, we do not anticipate widespread defaults or major losses at the bondholder level. Any defaults that do occur will likely be well telegraphed and identifiable through fundamental credit research. Nevertheless, the current risks surrounding the municipal bond market and the requirements of capital preservation and stable income from your core municipal bond allocation reaffirm the need for diversification, fundamental credit research, and a focus on high quality securities.

Disclosure

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