

The State of Muni Bonding

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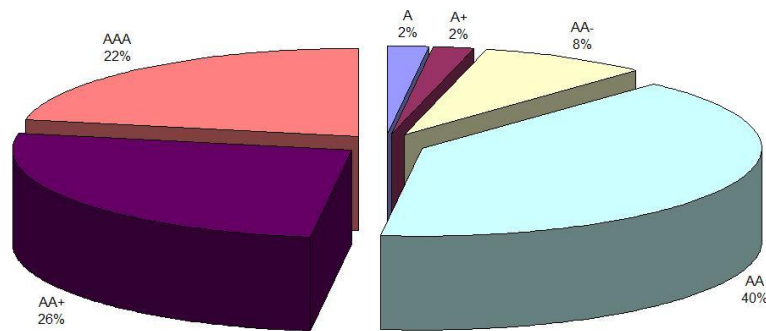
To hear tell from the headlines, you'd think that many state and local governments were on the brink of insolvency and about to default on their municipal bond obligations, as they struggle with declining tax revenues and skyrocketing demands for services. The actual situation for municipal bond investors, however, appears to be relatively stable. Most city councils and state legislators across the country are managing to meet their obligations to municipal bond investors. As a result, the vast majority of muni bonds remain well-suited investments for risk-averse investors. Here is a more detailed look at the current status of some of the most common municipal bond categories:

- General obligation bonds issued by state governments are often among the most visible muni market investments. While the fiscal travails of major states such as California, New York, and Pennsylvania may seem daunting, it is important to remember that in the history of the Standard & Poor's credit rating system, no rated state has ever defaulted on a general obligation bond issue, nor has any state even fallen below investment grade. What is more, despite the appearance of pervasive difficulty, only one state (California) is considered to be at risk of even a minor rating adjustment within the next six months, and that risk is expected to diminish as the economy improves.
- General obligation bonds issued by major cities and regional agencies might be considered slightly more risky as a class than state-issued bonds. But that's only because municipalities are treated differently from states under the U.S. Bankruptcy Code, the master law that defines how any borrower can use the court system to alter the terms of its debts. There is no provision whatsoever in the code for states to readjust their direct obligations. There is, however, a limited debt reorganization option for cities, towns, school districts, and similar entities using Chapter 9 of the code. Since the 1930s, no major city borrower has defaulted on general obligation debt. New York City's much-publicized struggles in the 1970s ended when the city refinanced certain notes; then-existing note holders were eventually made whole in the process, and the city today carries a near-perfect AA rating.
- Revenue bonds are the third broad category of munis. Where general obligation bonds give investors a direct claim on general tax receipts, revenue bonds are tied to project cash flows such as rental or toll collections. One advantage of these bonds is that as long as the project's cash flows, bondholders get paid, whether or not the issuer has any general budget or tax issues. The corresponding risk is that the project itself may become unable to support the debt service. Many issuers of revenue bonds take out insurance policies to cover debt service in the event of revenue shortfalls. Credit ratings on revenue bonds allow for the benefits of any available insurance. They also take account of the underlying viability of the project's revenue streams.

Action Steps for Investors

- If you currently hold individual municipal bonds, remember that a bond held to maturity is not subject to price fluctuations. If you do need to sell before maturity, identify which of your holdings are general obligations and which are revenue bonds, then determine the credit ratings on each. This knowledge may help you determine which bonds you might wish to sell and which you can comfortably hold on to.
- If you currently invest in a municipal bond fund, you can check current fund documents to determine the average credit rating of the fund. Then you can decide whether that average is within your personal comfort zone.
- For an extra measure of protection, look for individual bonds that include bond insurance, which can help protect you in the event of a default. If a bond you are considering does carry insurance, you should also look at the financial strength of the company that provides that insurance.
- Another form of investor protection is pre-refunding. Pre-refunded bonds are bonds that have been bundled with zero-coupon Treasuries that mature at the same time as the muni bond. Thus, cash from the redemption of the maturing Treasury is available to pay back the investor's principal.
- Keep in mind that, like other bonds, the market value of a muni rises when interest rates fall, and falls when rates rise. Bonds held to maturity may be redeemed at face value regardless of then-prevailing market rates.

Distribution of State Ratings in the Standard & Poor's System



Note: All 50 states are currently rated A or better for their general obligation debt. The lowest rating considered to be investment-grade is BBB-, which is three steps below A.

Source: Standard & Poor's, *U.S. State Ratings and Outlooks*, July 21, 2009, retrieved from Standard & Poor's RatingsDirect, August 4, 2009.