

The Muni Market Turmoil Continues: What's Going on and How to Respond

By Annette Thau

There have been a number of very bad years in the municipal bond market. But 2008 is in a league of its own—without any doubt, the worst year ever in the municipal bond market.

Last April, I wrote an article about steep declines in the muni market during the second half of February 2008 [“Turmoil in the Marketplace: What’s Going on With Munis?,” May 2008 *AAIL Journal*; available at AAIL.com]. The market subsequently rallied somewhat, but remained depressed.

A much steeper decline began in September, and as I write this (the second week of December), there is no end in sight. The declines taking place are unprecedented: particularly for bonds with long maturities and/or weaker credit quality.

This article will describe what has been taking place in the muni market. It will also briefly attempt to answer a number of questions:

- What lies behind the current declines?
- Are the current prices a buying opportunity?
- For the risk averse, where you can find safety?



all sectors of the fixed-income markets have experienced gut-wrenching declines. That contagion has spread to the municipal bond market, even though, in most cases, real credit quality of most municipal bonds has not been impaired.

It bears repeating that the credit quality of munis is second only to Treasuries. Default rates of munis are far lower than those of

corporates with the same ratings. For example, a recent study by the bond ratings firm Fitch Ratings compared default rates of run-of-the-mill general obligation bonds (without reference to their credit ratings) to the default rate of corporate bonds rated AAA. The default rate of the munis was under one quarter of one percent, compared to nearly one-half of one percent for AAA corporates. Default rates of revenue bonds were slightly higher, but well under 1%. (Private purpose municipal bonds—such as those of nursing homes, airports and toll roads—are higher, around 3%.) Another study by Fitch showed that defaults rise somewhat around recessions. But even in the depths of the great depression, defaults of municipal bonds remained relatively low.

The Credit Crisis and Munis

Before proceeding further, we should note that, since the financial crisis exploded into public consciousness, in September, with the exception of Treasury bonds and other debt explicitly guaranteed by the Treasury such as GNMA's,

Why Are Munis Declining?

So why is the municipal bond market tanking?

There are many contributing factors, including some of the factors discussed in my earlier article, which continue to weigh on the market.

Table 1. Treasuries vs. Munis: How the Yields Compare (as of December 12, 2008)

Maturity	Treasury Yields (%)	General Obligation Municipal Bond Yields (%)				
		AAA	AAA (Insured)	AA	A	BAA
1 Year	0.69	0.95	1.44	1.07	2.25	3.70
5 Years	1.51	2.96	3.46	3.12	4.24	5.72
10 Years	2.51	5.50	6.00	5.71	6.70	7.71
30 Years	3.04	5.81	6.21	6.00	6.94	7.91

Source: *WSJ.com* (for Treasury yields) and *The Bond Buyer* (for municipal bond yields).

The first is the collapse of the bond insurance firms. Their problems began in 2007, and they continued to worsen through 2008. Consequently, ratings of bond insurance firms have continued to sink. At the present time, bond insurance is no longer viewed as providing any protection to munis.

A second unsolved problem concerns the auction-rate securities mess, which has been only partially cleaned up. The auction-rate bond market included municipal issuers. Dislocations in that marketplace translate into a large supply of financings that have to be refinanced. (For a complete explanation of the auction-rate securities problem, see the sidebar to my May *AII Journal* article.)

But by far the greatest culprit in the current crisis is a severe liquidity crunch: There is an enormous wave of selling and a severe shortage of buyers. While individual investors (the so-called “retail buyer”) have always played a dominant role in the muni market, institutions such as banks, insurance companies and large broker-dealers, have always bought munis. More recently, hedge funds and investment banks used munis as part of complex trading and hedging strategies.

Since the financial crisis began, however, institutional buyers have almost totally disappeared. Indeed, not only are they not buying but, beginning in September, they sold, and they are continuing to sell. Hedge funds were some of the largest sellers: Many were forced to sell to unwind strategies that backfired, or to meet margin calls. Troubled banks, brokers, and insurance

firms desperate to raise cash, also sold large numbers of munis. Munis were sold because they were one asset class that was viewed as money good and therefore saleable.

Adding to the wave of selling were redemptions out of municipal bond mutual funds.

This enormous wave of selling created a huge imbalance between supply and demand. As a result, most of the sales took place and are continuing to take place at fire sale levels. The calendar year is limping to a particularly grim close as many brokerage firms are cutting back or shutting down their muni operations.

As I am writing this (the second week of December) the only buyer left standing is the retail investor—the individual investor. The very high current yields are attracting some buyers, but they are simply not enough to prevent a continuing and relentless slide in prices.

Performance

The traditional metric for evaluating whether munis are cheap (and therefore, offer attractive yields) is to compare yields of munis to those of Treasuries with similar maturities.

Because of the exemption from federal taxes (and also from taxes of the state in which the buyer resides), munis have always yielded less than Treasuries. Ratios have varied over time, based on such factors as the prevailing level of interest rates and prevailing tax rates. For any individual investor, the relative attractiveness of munis, compared

to taxable bonds, depended on their own tax bracket. In the past, municipal bonds with maturities of 10 years or longer typically yielded anywhere between 80% and 90% of Treasuries. Any time muni yields reached 90% of Treasuries (or higher), munis were considered cheap. That was because the net aftertax yield would be well above that of Treasuries even for investors in lower tax brackets.

The dislocations that have occurred this year have completely transformed the traditional yield ratio between Treasuries and munis. Toward the end of February 2008, the yield ratio of munis to Treasuries reached 130%, and that ratio stayed there for a couple of weeks. Subsequently, munis rallied but remained depressed, yielding somewhere around 100% of Treasuries.

Current ratios no longer bear any relationship to those prevailing even a few months earlier. During the past months, unprecedented flight-to-quality buying of Treasuries has pushed up Treasury prices, and reduced Treasury yields to the point where the shortest Treasury bills are yielding literally zero. But at the same time, steep price declines have pushed yield ratios of municipals to Treasuries to the highest levels ever recorded at every point of the yield curve.

Not all sectors of the muni market have been hit equally hard. Very high quality munis (AA, AAA) maturing in two or three years, have suffered minimal declines. But as maturity lengthens, and credit ratings are less stellar, prices have fallen off a cliff. Longer dated munis, maturing in 10 years or beyond, either unrated or with credit ratings below investment grade, have suffered price declines of 20% to 40% within the space of two or three months.

Table 1 compares yields of general obligation municipal bonds (the safest munis) to Treasuries listed for December 12, 2008. Note that ratings for munis are investment grade or higher.

A few facts in this table stand out:

- All municipal bond yields listed in this table are well above those

of Treasuries. Yield ratios of municipals to Treasuries for some maturities are higher than 200% or 300%.

- Yields are listed only for bonds with the highest credit ratings (AAA to A) or just slightly below. Yields for bonds below investment grade are not included, but would be still higher. (Bear in mind that as yields rise, prices decline correspondingly.)
- The widening of credit quality spreads for bonds of similar maturities is mind-boggling. In the past, spreads between AAA munis and the lowest investment-grade munis of the same maturity were about 50 basis points for short maturities and perhaps as much as 100 basis points for longer maturities—at the moment, for some maturities, spreads exceed 300 basis points.
- Note, also, that insured AAA bonds yield more than AA bonds that are not insured: A higher yield means that the bond is perceived as more risky. Clearly, bond insurance is no longer perceived to have value.

The yield ratios of municipals to Treasuries, as well as the widening of credit quality spreads would have been unimaginable even a couple of months ago. It bears repeating that the price declines are not tied to a rise in risk of default, but rather they are a consequence of the liquidity crunch described above, as well as the extreme risk aversion that pervades all markets and which the declines exacerbate.

Performance of Mutual Funds

If you own individual bonds and do not trade them, you may not even have been aware of the steep declines taking place in the muni market. Those were most evident, and most devastating, in bond funds, particularly those investing in riskier bonds—those with longer maturities and/or lower quality credits. Performance, however, varied significantly from fund to fund. A quick summary of performance provides a useful guide to potential future

performance.

For open-end mutual funds, returns can be grouped roughly by the average weighted maturity of the funds, and their credit quality. All returns are year-to-date (through December 11) for 2008, and are approximate:

- A very small group of funds invests in bonds with average maturities of one to two years. These are the so-called “ultra short” funds. Surprisingly, year-to-date returns for this group are actually positive: an average return of 2%, ranging from 1% for the worst-performing funds, to about 3% for the better ones.
- The next best returns were posted by intermediate funds, those with average weighted maturities between three and five years. Returns for this group averaged approximately –3.5%, ranging from a few funds posting positive returns, to –5% to –6% at the worst.
- The two largest groups of funds (based on asset values) are the many single-state funds and the so-called general national municipal funds. It is a dirty secret of the municipal bond fund industry that these funds are marketed on the basis of yield. As a result, most invest in bonds with the longest average weighted maturities that therefore have the highest interest rate risk. Average returns for single-state funds were –8.4%. For national municipal bond funds, average returns were –12%, with the best performers posting losses of –5% to the worst, around –20% or higher.
- The worst performance was experienced by so-called “high yield” funds, averaging –22%. The term “high yield” covers a group of funds with widely different strategies. Some buy bonds with long maturities (and hence high yield), but very high credit quality; at the other extreme are those that invest in bonds with the lowest credit ratings (such as tobacco bonds, or private enterprise bonds such as nursing homes); others buy

unrated bonds. Better-performing “high yield” funds posted returns of around –12 to –13%; funds investing in the riskiest bonds experienced truly shocking results of –30% and –48% year-to-date. The main cause of these declines was the unprecedented widening of credit quality spreads, noted in Table 1.

Closed-End Funds

The performance of closed-end funds, like that of open-end funds, was largely negative. But losses were amplified by the structure of these instruments. Closed-end funds issue a limited number of shares, which are sold on an exchange like a stock. The price of these funds does not always track the fund’s net asset value, but instead varies with demand. In addition, many closed-end funds use leverage in order to boost yield. Therefore, once again, performance varied significantly from fund to fund.

Bear in mind, also, that two prices are quoted for closed-end funds: Net asset value (which is the per share actual value of the bond portfolio); and share price (the market price of the funds) prior to commission costs. The share prices of closed-end funds typically trade at discounts to net asset value. In a broad decline, closed-end funds suffer a double whammy: the value of the bonds in the portfolio—net asset value—declines. When that happens, investors typically sell, magnifying the declines as the discount widens.

This year, for closed-end funds, average year-to-date net asset value results were negative, at –17%. Market price declines were higher, averaging –32%. Funds that use leverage were particularly hard hit; worst of all were those that used auction-rate securities for leverage and are having to refinance the issuance of preferred shares at a higher cost.

To make matters worse, one fund group—Pimco—recently announced that it was suspending dividend distributions on several of its closed-end

municipal bond funds. (Dividends were suspended for technical reasons: Closed-end fund regulations require a minimum reserve; distributing the dividend would have reduced the reserve to below required levels.) It is possible (likely?) that other closed-end funds may either suspend or cut dividends, which would result in more sales, and further declines.

Exchange-Traded Funds

Municipal bond exchange-traded funds (ETFs) were introduced about a year ago, in retrospect, not an auspicious time. At the moment, there are only a few muni ETFs, and most have not existed long enough to have a meaningful record of performance. But ETFs may in the future provide excellent vehicles for investing in municipals through funds. Returns should mirror those of the better-managed mutual funds—expenses are low and most are managed passively.

Where Do We Go From Here?

The answer is that no one knows.

Recent declines have resulted in a market environment that is unlike any previous environment. Markets have suffered such severe dislocations that the landscape is not recognizable. The municipal bond market could continue to weaken for a while, although ultimately, things should return to “normal.” But what that “normal” will look like, or when it will happen, is unclear.

So, how does one proceed?

Only you can decide what would make sense in your own situation. But I can try to put the situation in perspective and make some suggestions.

Some Pluses

If you evaluate municipal bonds by the traditional criterion, the yield ratio of municipal bonds to Treasuries of the same maturity, munis are incredibly cheap: All along the yield curve, munis yield, in absolute terms, anywhere between 150% to even 300% of Treasuries. Because of the tax exemption, a 10-year

municipal bond yielding between 4.5% and 5.5% has a tax-equivalent-yield, depending on tax brackets, of 6% to 7%. Tax-equivalent-yields on longer-maturity municipals approach 10% (again, depending on tax brackets).

These unprecedented ratios suggest that munis are the buy of a lifetime. Unfortunately, articles pointing to the prevailing extremely high yields in the municipal market have been appearing since the beginning of October—and since then, prices of longer-term or lower-rated munis have continued to slide down a cliff. Clearly, calling the bottom of a market is no easier for the bond market than it is for the stock market.

However, there are some positives. The first is the very high ratio of municipal bond yields to Treasury yields. There is no question that if the current economic crisis subsides, and ratios of munis to Treasuries go back to anywhere near traditional ratios (even to ratios which formerly would have been considered high—for example, 100%), then munis bought at the current time may prove to be the buy of a lifetime.

Moreover, if investors anticipate a rise in tax rates, then that too will cause municipals to look even more attractive.

But my sense is that the market is likely to remain rocky—and prices volatile—for the foreseeable future.

Some Red Flags

Why am I being so cautious?

For yields to “normalize” panic-selling has to stop and buyers have to appear. Confidence has to be restored.

The critical imponderable for the municipal market is whether or not institutional buyers return in large numbers. At the current time, with banks, insurance firms, hedge funds, and broker-dealers in dire straits, it is not clear where the institutional buyer will come from.

Note, also, that the yield of Treasuries is artificially depressed as investors from all over the world have fled other assets in favor of Treasuries. How long can Treasuries continue to attract buy-

ers at these levels? No one can say. But if yields of Treasuries rise, then the current spreads between municipals and Treasuries will narrow, perhaps significantly.

Moreover, a prolonged recession will translate into rating downgrades. Even though actual defaults are unlikely to rise significantly, downgrades are likely to cause the market to remain at least subdued, if not depressed.

Finally, I am writing this article in December and you are reading this in January. Hopefully, the market has come off the lows recorded in December. But bear in mind that between September and the end of 2008, due to the severe dislocations occurring in the municipal market, many issuers opted to postpone issuing bonds. Sales cannot be postponed indefinitely, and a potentially heavy supply of new issues at the beginning of 2009 may continue to depress the municipal market.

What Should Investors Do?

The question of the hour is: Should you buy, should you sell, or should you do nothing?

The answers will be different if we are talking about investing new money, or dealing with losses.

Current Muni Holders

Most people buy municipal bonds for income. They don't expect to make a fortune, but they also don't expect to see prices plummet within a couple of months. On the other hand, this is an asset class that has a very low risk of default.

If my scenario makes sense—no quick turnaround but a gradual “recovery” in the muni market—for most investors, the best course of action is to “stay the course” (much as I dislike that cliché). You don't want to sell now because you have experienced a loss and buy back later after prices have gone up: That is selling low and buying high, and that is not a good thing.

The question, however, is much more painful if you own a fund that has experienced serious losses, say 20% or

more. A loss of this magnitude tells you that the fund is invested in the riskiest bonds. Such a fund is likely to post the highest yields, but to be very volatile, and you have to decide whether this continues to be appropriate for you.

One suggestion that is often made is to “harvest” tax losses, by swapping: selling one fund (or one bond), and buying another. It is too late to harvest losses for 2008 but you have all of 2009 ahead of you. You have to be mindful of the “wash sale” rule (you cannot claim a tax loss if you buy back the same security within 30 days of the sale). But it is not difficult to swap a bond (or a bond fund) for another with similar maturity and credit quality. However, be mindful that there are costs to swaps.

One possible gain from a swap, if this is money that you cannot afford to lose, would be to swap into a more conservatively managed, less risky fund (or a higher-quality, shorter individual bond). The trade-off, however, is that the yield in each instance will be lower.

New Purchases

The question is very different if you have new money that you want to invest.

For new purchases, the recommendations made at the end of my earlier article continue to apply.

- If you are risk averse, or if you are investing money that you cannot afford to lose, and if you invest through funds, then invest only in the safest, most conservatively managed funds. As noted above, even during this disastrous year, there have been safe harbors. Those were bond funds with very short average maturities (under two years). Those, however, quote the lowest yields.
- Intermediate funds may offer the

best option. They have experienced modest losses (averaging 3%): but the maturities are long enough, and the yields high enough that they will benefit from an eventual recovery.

- Funds with longer average weighted maturities or lower quality ratings have been marked down out of all proportion to the genuine risk of default of the portfolios. When and if the muni market recovers, they may have higher gains—that is not guaranteed, however, and they will be subject to much greater volatility.
- Much of this article has focused mainly on bond funds. But if you invest primarily for income, I would suggest that you buy individual bonds. If you hold to maturity (barring default), you get back 100% of your principal no matter what has happened to the market. The safest bonds to buy are high-quality (AA, AAA) bonds, maturing between five and 15 years. These bonds offer the best trade-off between yield and volatility.

For buyers who can afford to speculate, current yields in many sectors of the muni market offer the potential for equity-like returns. But here again, some caveats apply.

- Stick to higher-quality offerings.
- If you are buying funds (open- or closed-end), look at the returns of the funds this past year: I would avoid funds that lost more than 20% in 2008, or funds whose yield exceeds 6.5% (that tells you that the portfolio contains the riskiest bonds).
- If you want to buy conservatively managed funds, check the make-up of the portfolio before investing.

The average weighted maturity of the fund should be below 12 years, and at least 50% of the fund should be investment grade or higher (A to AAA) bonds. The trade-off is that yield will be lower than for riskier funds.

- Note that at the time of this writing, some muni funds are quoting yields above 10%. That yield is the result of huge declines in price. While that yield is tempting, be aware that funds with such yields are likely to be highly volatile. Note also that closed-end funds with similar yields may cut or suspend the dividend, which would in all likelihood result in further declines in price per share.
- Also, given the current environment, it would seem prudent to invest gradually, over a period of several months.

One Final Caution

The flight-to-quality buying of Treasuries is partly motivated by the perception that those are the safest securities. And certainly, there is no default risk and therefore no credit risk.

But Treasury bonds are subject to interest-rate risk, like any other bonds. Ten-year Treasury yields are currently hovering at 2.6%; 30-year yields are at 3%. If the yields on either the 10-year or the 20-year bonds were to rise modestly—say, to 3.5% for the 10-year, and the 30-year to 4%—the market value of the bonds (or of bond funds investing in long-term Treasuries) would decline by 20% to 30%.

By those criteria, 10- to 30-year municipal bonds yielding 4.5% to 6% before taxes would appear to be the safer buy. ▲

Annette Thau, Ph.D., is author of “The Bond Book: Everything Investors Need to Know About Treasuries, Municipals, GNMA’s, Corporates, Zeros, Bond Funds, Money Market Funds, and More” (copyright 2001, published by McGraw-Hill; \$29.95). She has spoken to AAIL chapters in different parts of the country about bonds. Ms. Thau is a former municipal bond analyst for Chase Manhattan Bank and was a visiting scholar at the Columbia University Graduate School of Business.

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