Fixed Income Market Commentary

December 2013

The Other 99.95%

According to credit ratings company Moody's, there are approximately 15,000 different issuers in the $3.7 trillion municipal bond market.

Municipal bond issuers come in all shapes, sizes and credit quality. Through November, seven of those issuers rated by Moody's defaulted on their bond debt this year. To me, that number is startling because it is so small—especially compared to the projections and some of the headlines we have seen recently that might have led you to believe it would be much higher. The reality doesn't lend much credence to those pundits who have been advising investors to avoid the municipal market.

Municipal bonds, which help finance the necessary construction of everything from new schools to hospitals, from highways to water treatment plants and so much more, are a huge market. They can be somewhat complex and are not without some risk. As is the case with any group of borrowers, whether they are corporations, sovereign national governments, local and municipal governments or even individuals, there will be some that fall upon hard times and ultimately, default.

Lending money isn't risk free, and the municipal bond market isn't risk free either. However, if only seven out of 15,000 issuers defaulted, it means that 99.95% did not.

Of course, this does not mean that all of those issuers who avoided default are on equal footing. As it should be clear to anyone doing just a modest amount of research, they are not. Some issuers I wouldn't touch with the proverbial 10-foot pole and for good reason—they represent more risk than I am willing to take in the portfolios I manage. There are other factors, too.

A recent *New York Times* article pointed to the rough year for many muni bond investors in part because the municipal bond index that tracks the performance of the market was down 2% year-to-date. While highlighting some of the pitfalls in the municipal market, the *Times* leaves readers thinking that the reason for the year's poor performance is tied to poor disclosure on unfunded pension liabilities. Unfunded liabilities are a concern, but the real reason for so much of 2013's weakness lies elsewhere and has a much simpler explanation. Long-duration and long-maturity bonds' prices were significantly harmed when investor expectations for the tapering of asset purchases by the Federal Reserve bubbled up earlier this year. The tapering of asset purchases never happened, but the damage to the prices of long maturity bonds was done.

Taper expectations weren't the only reason interest rates crept higher and prices lower. The yield on the municipal bond index rose from 2.0% in early May to around 3.1% today. The move higher has a lot more to do with economic growth and inflation expectations than large-scale investor worries about pension liabilities.

More to the point I wish to make, the five-year part of the municipal bond index is up 0.9% on a year-to-date basis, while the 22-plus-years component is down 6.1%. Does this mean that the longer component is where all the bad bonds are buried? Are only good bonds included in the five-year component? The answer, of course, is no.

The message is that there is a lot that goes into selecting which bonds go into our portfolios. Disclosures about a city or state's pension liabilities matter, but in 2013 what mattered more was structure. Having the right structure meant the difference between capturing a year of positive returns or negative returns. Going into 2014, the greater risk to the vast majority of municipal bond investors is the headline risk of bad publicity, not defaults. Remember—bonds are an asset class to be managed, not abandoned because of troublesome headlines that a slim few create.

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