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TRUST SERVICES

Munis still looking good, despite new risks

Historically, municipal bonds have been the Mr. Rogers of investment options: a gentle, risk-free, tax-exempt way to protect wealth.

Then came the fourth quarter of 2008, with its stock market crash and Round One of federal government bailouts. Distressed institutional investors pulled out of the muni market, making the problem worse.

A rocky road

This year, rising unemployment derailed state income tax revenue streams, and the resulting consumer cutback has harmed sales tax flows. California headlines have declared that the state is teetering on bankruptcy, and a federal investigation has uncovered mounting evidence of bid-rigging, collusion and tax evasion in the municipal bond world. Furthermore, insurance on some municipal bond issues has turned out to be too undercapitalized to be useful during a default.

Munis, to be blunt, have been bloodied. In early December 2008 the Port Authority of New York and New Jersey couldn't auction \$300 million dollars' worth of bonds on a three-year term.

Optimistic investors, on the other hand, point to the fact that even Detroit, which defaulted on its municipal bond debt during the Great Depression, eventually paid up, and not even 2% of munis defaulted at all. The difference between a municipality and a corporation is that the city doesn't disappear, points out David W. Hemingway, chairman of Zions Direct. Still, skeptics argue, this isn't the 1930s. Creative financing and more highly leveraged cities make it a new ballgame.

A promising recovery

The municipal bond market is in recovery mode now. The best evidence is that money has been pouring into muni bond mutual funds. According to Lipper FMI, during an eight-week period in the third quarter the funds reported average weekly inflows of \$2.51 billion, and \$2.47 billion weekly in market gains. Why? You could chalk it up to a proven, powerful motivation: unmistakable signs that federal income taxes will rocket higher in the next 24 months. There's also the group of investors who fear stock volatility more than these muni risks. So what's really changed is the buying strategy rather than the product itself.

The prevailing advice is to stick to state general obligation bonds, relying on their taxing authority and, in some cases, constitutional mandates to pay their general obligations first, right behind school bonds. And with scandals swirling, it may make sense to turn to mutual funds and take advantage of not only their ability to spread the risk but also their sophisticated research skills. The drawback: They may gravitate toward long-term maturities, which are ripe for a

pounding if the United States experiences runaway inflation. Mutual funds also cost you control, fees, and a risk of loss in a rising interest rate environment.

The savvier solution may be to invest on a laddered basis, investing in longer-term munis as well as 2-, 3-, and 4-year local muni offerings—as long as you do your due diligence. Buying Main Street bonds makes sense only if the municipality is financially stable, a detail that's easily lost in the emotion and pride of your hometown. Certainly, confer with your banking advisor before hitting the buy button.

The final review

If you want ultra security, Treasury bonds remain the fortress in a scary financial world. However, a 30-year T-bond might yield 4%. A 20- or 30-year muni may deliver closer to 6% or 7% on a taxable equivalent basis, and it is safer than a corporate bond at the same rating, based upon default histories. From that perspective, many investors find the risks reasonable.

(November 2009)

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