

May 31, 2011

## **Staying Sane Amidst the Municipal Madness**

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Analogies are very powerful narrative devices. When a pundit or politician compares something unfamiliar to something that is familiar, he or she re-organizes information in a way that makes it easier to understand. Unfortunately, if the two things being compared are actually quite different – and only sound similar due to rhetorical flair – then listeners may reach an inaccurate conclusion.

Recently, more than a few investment experts have compared the implosion of subprime mortgage securities a few years ago to the current state of the municipal bond market. On the surface, this sounds pretty scary. After all, housing was the “safe” asset that rarely declined in value – until it cratered. Homeownership rates always went up – until they reversed. And people with jobs always stayed current on their mortgage payments -- until “strategic default” and “jingle mail” entered the national lexicon.

The result is that nervous investors are psychologically primed to look for the next blowup in a once-steady asset class, and media coverage of how [even wealthy communities can't pay their bills](#) confirms their fears. Obviously, the muni bond market is a disaster waiting to happen – except that it's not. And obviously, only an idiot would think muni bonds are cheap – in which case, call me the idiot du jour.

### **Dysfunctional and Insolvent Are Not the Same**

There are approximately eight bazillion reasons why the average municipality is more likely to stay current on its debt than the average subprime borrower. A short list might mention:

- An overleveraged homeowner can choose to rent his or her primary residence, or to just walk away from a second home. An overleveraged municipality is a perpetual entity that cannot up stakes and move.
- The typical homeowner pays about one-third of income on housing (mortgage, taxes, insurance). The typical municipality spends 5% of annual expenditures on debt service.
- A homeowner who loses his job has a drastic change in cash flow. Recessions hurt state/municipality income, but tax revenue does not drop by 80%.
- Loans to municipalities and states were not made during a massive asset bubble, as residential loans were.

Most of these issues – among others – have been discussed in the investment media. (Thanks to Mike Schroeder, CIO of [Wasmer Schroeder](#), for helping to compile a list.) However, I think the key reason why whatever transpires in the muni market will be far milder than the subprime debacle is really very simple: The folks who loaned money to states and municipalities actually cared if they got paid back, whereas many (most?) lenders to subprime borrowers had no intention of holding the loan to maturity.

If you're paid to make a loan that will be sold ASAP to the first fool buyer you can find, your goal will be to put as much lipstick on as many pigs as possible, and then get those pigs out the door. By contrast, if you plan on holding a loan, you'll look much more carefully at whether that loan will actually be repaid.

### **Incentives Matter**

The key to whether any loan will be “money good” is the cash flow that the underlying asset generates, as forecasted at the time the loan is made, since those forecasts determine the amount of the loan and the rate charged on the loan. As we know, for residential real estate in 2003-2006, many of these forecasts were made

by individuals with incentives tied to closing the loan, rather than incentives tied to whether the borrower could make the required payments. So, loans were made based on (often willfully) inaccurate forecasts of borrowers' ability to repay.

By contrast, loans to states and municipalities have always been made (and are still being made) in a market-based environment by entities that plan to hold the loan themselves. While these buyers will not be 100% accurate in their forecasts of municipalities' ability to repay a loan, it is virtually certain that they will be more accurate (on average) than a loan officer during a housing bubble itching to make his "production" numbers for the month, with little incentive to properly analyze the ability of the borrower to make payments.

This is the heart of the false analogy between the muni market and the subprime mortgage market: The muni market has never had the type of mis-aligned incentives which were prevalent in the mortgage market during the housing bubble. Again, not all parties setting the price of new muni issues have had perfectly accurate information or perfectly aligned incentives, but municipal entities do not get loans based on an undocumented 30-minute conversation with a mortgage broker. Plenty of residential loans were made on such a basis.

Finally, while the value of some muni-bond "collateral" has arguably declined as tax revenue has declined, this is more analogous to a residential borrower getting a pay cut (less overtime, say), than it is to a precipitous collapse in the value of the collateral. There are many, many areas of the country where residential real-estate prices have declined by 20% or more. Yet only one state (Alaska), had a FY 2010 tax take more than 20% lower than its 2008 tax take.

#### Where the Rubber Meets the Road

While the municipal bond market has bounced quite a bit off its recent lows, the selloff in munis caused by purveyors of the false subprime analogy has created some fairly attractive yields for higher-bracket investors. Granted, these are not fat yields in an absolute sense, but relative to other parts of the bond market, munis look like one of the few bargain priced areas.

Consider three actively-managed, low-cost mutual funds from Vanguard: One that invests in investment-grade corporate bonds, one that invests in high-yield corporate bonds, and one that invests in municipal bonds. All three are intermediate-term funds, with roughly the same maturities and durations. (At the Trust Company, we use Vanguard funds when bond funds are more appropriate than individual issues.)

For an investor in the 28% tax bracket, the investment grade fund yields 3.5%, the high-yield fund yields 5.75%, and the muni fund has a taxable-equivalent yield of 4.2%. However, the muni fund has a much higher credit quality than either of the corporate-bond funds, with only 5% of its portfolio in bonds with less than an "A" rating. So, higher-bracket investors can get more income with less credit risk by buying munis rather than investment-grade corporates. The high-yield corporate portfolio does offer more income, but takes substantially more credit risk to do so.

More income for a similar level of interest-rate risk -- and less credit risk -- is the bond-market equivalent of a good deal. While some savvy investors have figured this out, as evidenced by the big rally in municipal bonds so far this year, I don't think the window of opportunity has closed quite yet.

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