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Misconceptions Currently Hurting Municipal Bonds

According to the Investment Company Institute, outflows from open-end municipal (muni) funds have been approximately \$22 billion since the beginning of November, 2010. Owing to the fact that municipal bond investors tend to be more conservative and averse to volatility, I believe much of the weakness is related to overblown fears about the potential for a significant wave of defaults.

One trigger to the bond market weakness came on December 19, 2010 when an analyst went on a popular prime time news program suggesting that this year there could be "50-100 sizeable defaults worth hundreds of billions of dollars." The problem with this assertion is that according to a December 21, 2010 Citigroup report, the top 50-100 municipalities in this country do not even have "hundreds of billions of dollars" of debt outstanding. By the way, according to Marketwatch.com, there has only been one municipal bond default since the week of December 19th, which was valued at only \$6 million.

It has been argued that budget issues confronting states are as bad as budget issues confronting countries such as Greece or Ireland. According to the International Monetary Fund, Greece's debt as a percent of its gross domestic product (GDP) is estimated at over 100%, while Ireland's is around 55%. To put that in perspective, the median for all 50 states is only 2.2%, according to MarketWatch.

According to Bloomberg, municipal bond defaults hit a record of \$8.15 billion in 2008. That same year, \$157.7 billion worth of corporate bonds defaulted, according to Forbes. Municipal bond defaults have since declined to just \$2.52 billion in 2010. Part of the reason defaults have been declining is because revenues have been increasing for many states and municipalities the past year. Rockefeller Institute data shows that for the most recent quarter where data is available (3Q 2010), local and state revenue has increased for the third straight quarter. Additionally, many states, cities and towns have raised taxes significantly, cut services and cut budgets in order to get their balance sheets healthier.

In my opinion, very attractive opportunities are now present in municipal bonds and municipal closed-end funds (CEFs). The average yield on 30-year AAA rated municipal bonds is now approximately 5.01%, the highest since January 2009, which was during the teeth of the financial panic. Moreover, municipal CEFs, now have an average yield of 7.4%, and offer an attractive discount of 2.50% on average as of January 14, 2011, according to Morningstar.

We are in the panic/capitulation stage where investors ignore the facts and simply sell no matter how compelling the asset class is. However, ultimately the facts and the fundamentals will matter and I continue to believe that municipal CEFs and the underlying asset class of municipal bonds are prepared to bounce back and perform better. It is important to note that the overwhelming majority of the 256 municipal CEFs are investment grade and are diversified across dozens if not hundreds of different municipal bonds.

Municipal Bond Facts

- The muni market is enormous with a size of over \$2.9 trillion and over 55,000 different issuers, according to the Municipal Securities Rulemaking Board.
- In a Moody's study that covered 1970-2009, only 54 of the 18,400 municipal bonds they rated had defaulted. Of those, only 5 involved general obligation debt.
- In a Fitch study covering the period from 1999-2009, only 10 entities defaulted, which equates to an average annual default rate of 0.04% over those 10 years.
- Even during the Great Depression the default rate for municipal bonds only reached 1.7%.
- The number of AAA-rated counties—the highest bond rating—has risen from 42 in October 2006 to 67, with 20 counties making the jump in the past two years, according to a January 2011 Standard and Poor's report.

Average % Discount of All Municipal CEFs



Source: Morningstar

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