

Why Munis Now?



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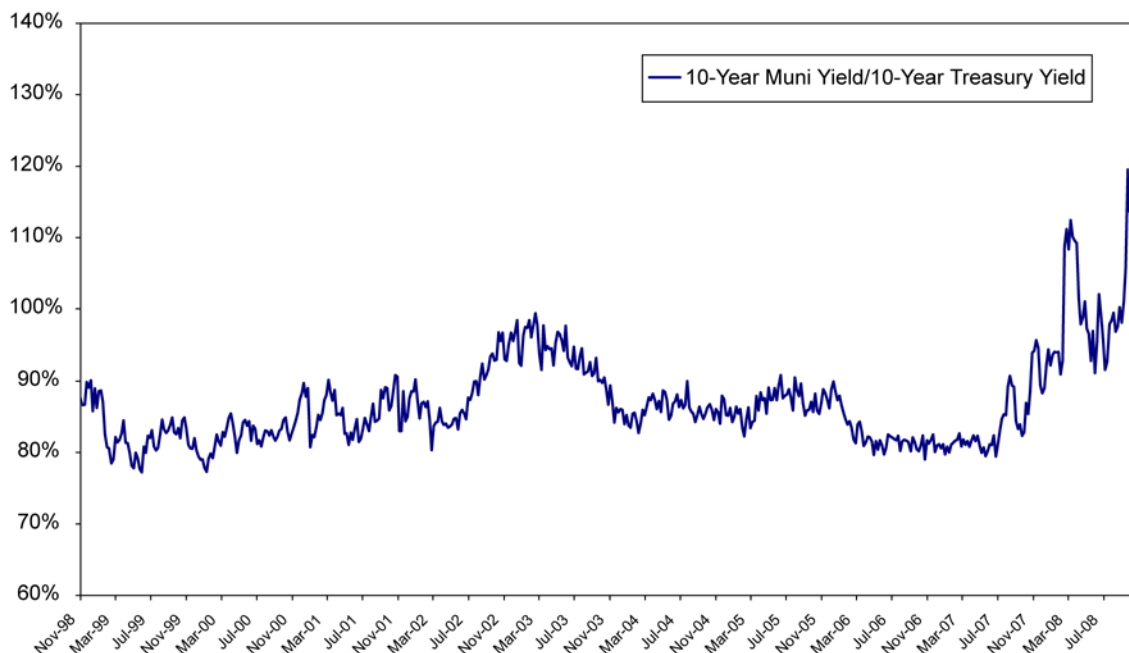
A few months back my colleague Christopher Keith penned an article ([The Benefits of Bonds](#)) in which he profiles an argument for fixed income as part of a balanced and diversified portfolio. In this article I would like to spotlight one area of the fixed income market and the opportunities that are present there: the municipal bond market.

Relative Value

With the exceptions of cash and nominal Treasuries, no area of the market has been unharmed during this period of market upheaval. Munis are no exception: Over the past 12 months (ending 10/31/08) the Lehman Municipal Index had lost 3.30% while the Lehman U.S. Government Index gained 6.82%. Munis have underperformed Government securities by over 10%. Over the past 20 years, this is the second largest margin munis have underperformed by over a 12 month period (the largest margin was earlier this year). But it is often during periods of market dislocation when values can be discovered.

One way that municipal bonds are often evaluated is by comparing their tax-exempt yields to the yields on similar maturity US Treasuries. This figure is typically quoted as a percentage of the Treasury's yield. For example, if a ten-year municipal bond is yielding 3.20% and a similar ten-year Treasury yields 4.00%, we would say the municipal bond yields 80% of Treasuries ($3.20 / 4.00 = 0.80$). As seen below, munis trade at a long-term average of 80-85% (depending where on the curve you look) of Treasuries. We would expect this as yields are quoted on a pre-tax basis. However, as seen in our graph, this relationship recently diverged sharply from its long-term average. Munis began to yield well in excess of 100% of Treasuries: Even before taxes, munis currently yield more than Treasuries.

Munis as Percentage of Treasuries



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Red Flags

As investors, whenever we are presented with a situation that varies sharply from the norm or seems too good to be true, red flags should go up. We should always ask what created this opportunity? Or what am I missing? In this particular case, one answer could be that as the economy slows, municipalities will come under pressure as revenues decline. Municipalities will then be faced with decisions surrounding budget cuts, tax increases, and asset sales to meet obligations and balance budgets. With this increased pressure on municipalities and risk to municipal bonds, it would be logical for investors to demand higher yields. While this is certainly a factor, I would argue that it alone does not explain the dramatic spike in the muni to Treasury ratio.

Safe-Haven?

Munis were historically viewed as a safe-haven by investors during difficult times. In a report produced by Fidelity, since 1970 less than 0.1% of all investment grade bonds have gone into default. If we look at BBB-rated bonds (lowest rated investment grade), only 0.1% of municipal bonds defaulted versus 4.6% of corporate bonds.

When we look back at the history of the municipal bond market we see that even in the rare cases of a default, investors often received full par and interest with time. One example would be the prominent municipal bankruptcy of Orange County, CA in 1994. An aggressive leveraging plan and bet on interest rates pushed Orange County to file for bankruptcy. Out of the bankruptcy emerged a new bond program with a special tax designated for the benefit of the new bondholders. The proceeds were used to pay par and accrued interest to the original bond holders.

Other Factors at Play

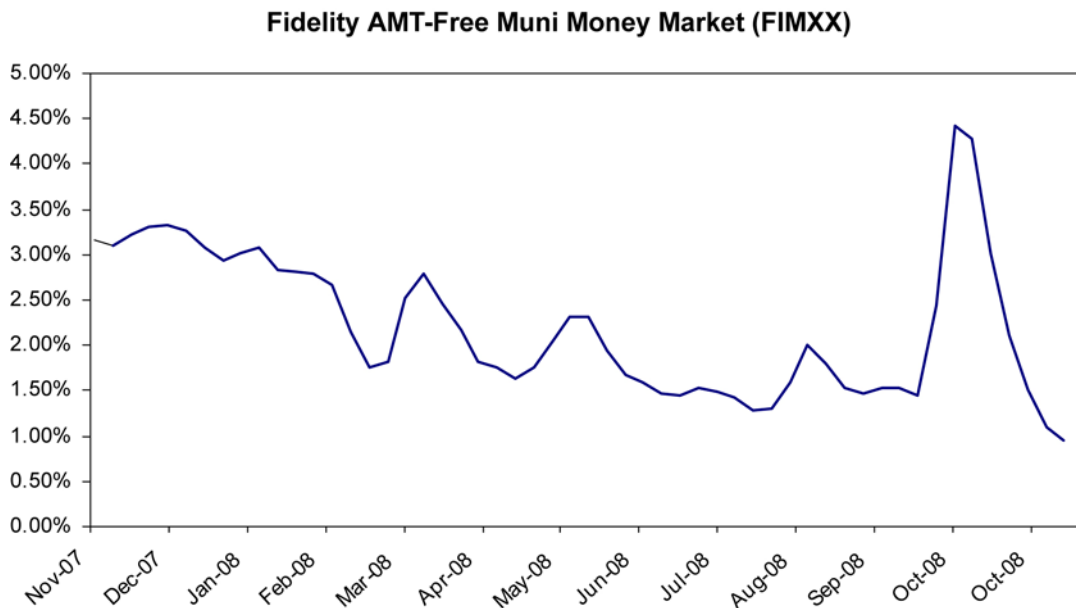
So if it is not credit concerns that are entirely responsible for the dislocation between muni and Treasury yields, what other factors could be playing a role? Those factors include liquidity and deleveraging. The first signs of this were seen in the beginning of the year when auctions for auction rate securities began to fail as broker/dealers were no longer willing to absorb (take on to their books) any excess supply. At that time the muni to Treasury ratio also diverged from the long-term average. However, as that liquidity issue began to clear, the relationship returned toward normal levels. In September and October, the muni market saw another round of deleveraging as hedge funds were forced to unwind their positions. But it is not only hedge funds that have been forced to sell into this market, as mutual funds facing redemptions contributed. For example, in mid-October Schroders announced that they were liquidating two muni bond funds in light of increased investor redemptions. This forced selling and deleveraging created an imbalance between supply and demand.

Other factors that played an important role in creating opportunities in the muni market are fear and uncertainty. The yields on muni money market funds over the past two months demonstrate how fear and uncertainty affected the market. Common investments of money market funds are variable rate demand notes (VRDNs). These instruments pay a variable interest rate (typically tied to money market yields) and are payable on demand. At their discretion holders may request repayment of the entire debt and the counterparty has an obligation to meet the demand. With the collapse of Lehman Brothers and the “breaking of the

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buck” by a prominent money market fund, fear and uncertainty spread across the market. Money market funds became concerned with the prospect of meeting significant redemptions. There were also questions about the ability of broker/dealers to meet the obligation of VRDNs. If this scenario played out and the VRDNs were not repaid in a timely manner, money markets would be a risk of breaking the buck. As the chart below demonstrates, rates on money market yields (the Fidelity AMT-Free Muni Money Market serves as a proxy for national yields) spiked sharply in September and remained elevated through mid-October. Actions taken by the US Government have served to alleviate these concerns; however this serves as another example of the dislocation that affects the muni market.



Opportunity Remains

In recent weeks the conditions in the municipal market have improved – as seen by the drop in the muni to Treasury ratio and decline in short rates. As mentioned above, municipalities will face difficulties and continue to make headlines as their revenues come under pressure. Additionally, issuance slowed during this recent period of dislocation and supply overhangs the market. But municipalities have faced numerous economic cycles and municipal bonds have held up very well through those cycles. The market will also work through the supply with time, as it has in the past. A rebound in the muni market is likely to take time and volatility will persist. However if you believe that markets will stabilize, then munis may be an attractive alternative to Treasuries. Additionally, if one believes that tax hikes are inevitable under President-elect Barack Obama, then muni bonds should be even more attractive.

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