Municipal Bonds Have Teeth: Do They Need Braces?

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Peter J. Schmitt recently cracked the veneer of municipal bonds, commonly thought to be ultra safe because of their traditionally rare defaults. He writes that munis can have credit problems that are not appreciated, especially by the individual investor. His paper entitled "The Consequences of Poor Disclosure Enforcement in the Municipal Securities Market" can be found at DPC DATA.

Schmitt suggests there is poor federal regulation of municipals, which leaves them policing themselves. He says they do this poorly, and there is little penalty for not complying with regulations. As a result, whatever information is available tends to go to big bond buyers rather than the smaller participant. This means the individual is more likely to buy less than credit worthy bonds or continue to hold downgraded bonds until they completely expire.

But, there are solutions. One is to buy extremely high quality bonds that are unlikely to default. There is a downside of course. They won't provide the returns a poorer quality bond would. Sleeping at night is exchanged for a higher return.

Also, bonds from a municipality and state with good financials will, on average, have less chance of default. If you have a Bloomberg terminal you can look up the municipality rating or your broker can do this for you. As of a few months ago, the states that did not have a budget gap included Texas, Louisiana, Missouri, Indiana, Nebraska, South Dakota, North Dakota, Wyoming, Montana , Oregon, and Washington. Notice that all but one represents the central section of American, a more fiscally conservative area. The only downside here for the bond buyer is that the choices become limited.

Of course, insurance for the bond is always a plus. Though there were a plethora of insurance companies that investors could trust, this has changed in the current economic environment. Now, generally speaking, only Assured Guarantee, FSA insurance, and Berkshire Hathaway are considered credit worthy (AAA/AA3). Again, the only downside is that insisting on this insurance restricts the selection.

Lastly, there is one sure way for a municipal bond to be a winner. If it is escrowed or pre-refunded, the principal and interest have already been reimbursed so payment to the bond holder is secure. These bonds are rarely downgraded because they are protected. A downside is that they are also difficult to find in the municipal bond marketplace individually because they are so sought after.

For those who don't want to take the trouble to take the steps above, there is a solution. It is a new exchange traded fund (ETF) that carries the symbol PRB, an apt representative for pre-refunded municipal bonds. Its total net expense ratio is 0.24%. Since it was launched in February 2009, its price has fluctuated between $24.07 and $25.67 per share. It is still a small fund (9.80 million) so the gap between the bid and ask can be large as demand is slim so far. That is a downside, as the price paid may be unusually high or the price at which it is sold could be excessively low. Limit orders, of course, could take care of this shortcoming.

In a **Mouthful**

Municipal bonds can be the **teeth** of your bond portfolio if chosen well.

In order to **brace** them up for security:

- Choose high quality
- In states without a budget gap
- That are adequately insured
- And, are pre-funded.

An alternative, that is analogous to getting a **set of false teeth**, is buying a fund with bonds already chosen for you. Though this is easier than laboriously picking bonds yourself, it may be costly. PRB, the new Van Eck pre-refunded municipal bond exchanged trade fund, is one option.