



Undoing Meredith Whitney's Damage

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Meredith Whitney did the municipal bond market an immense disservice with her misguided comments on *60 Minutes* in December when she predicted massive municipal defaults. Two recent articles in this publication provided accurate rebuttals to her analysis, but they failed to clarify important reasons why muni bond investors do not face the imminent peril that Whitney predicted.

Individual bond holders do not face the same risks as funds

In [Refuting Meredith Whitney](#), which appeared on January 18, Robert Huebscher stated that Robin Prunty, a senior director in S&P's public finance ratings group, "argued persuasively that states are fiscally solvent." At the same time, however, he pointed out that spreads can widen on the perceived risk of downgrades. While this is true, the municipal bond buyer who purchases individual bonds, intending to hold them to maturity, recognizes that price fluctuation is an unpleasant fact of life when interest rates rise and prices drop. Changes in price do not mean that default is imminent or that there is reason to worry about credit quality.

Though bond holders always prefer to see the value of their portfolios increase, as advisors we educate our clients to understand that price declines can also be to their advantage. Those declines can actually benefit individual investors who have bond ladders in place. Ladders enable investors to increase the cash flow from their portfolio when bonds mature and proceeds are reinvested in higher-yielding additional bonds.

Investors must heed the basic assumption of the yield-to-maturity calculation: that you will reinvest interest payments at the same yield as the stated yield-to-maturity. When the reinvestment yield is higher, the effective return to the investor increases.

Unlike a mutual fund bond investor who suffers an immediate loss when interest rates increase and the value of their holdings drop, the individual bond investor can hold their bonds until their due date and sustain no loss. Their bonds keep paying interest and will eventually come due at face value. Unless an investor is forced to sell, he or she doesn't have to realize any losses. And if the price of an individual bond decreased due to interest rate fluctuations, it should eventually increase in value as the bond approaches its due date.



The tax status of munis is secure

In Robert Huebscher's article, [Jeffrey Gundlach: The Greatest Investment Opportunity of 2011 and 2012](#), which also appeared on January 18, Gundlach suggested that the taxation of municipal bond income would be a "polite default" on the part of states or the federal government. Indeed, the federal government has already nibbled away at the muni tax exemption in the form of higher Part B Medicare payments, adding tax-exempt muni bond interest when determining whether social security payments are subject to tax, and subjecting certain bond interest to the alternative minimum tax.

I don't believe that the tax exemption will be repealed. According to data from the Investment Company Institute, approximately 70% of muni bonds, including those held in funds, are held by individuals. It is not just the wealthy who buy muni bonds; data show that many in the 25% marginal income tax bracket hold munis. These investors are not wealthy; they are just not poor.

Gundlach sees muni bond holders as a highly homogeneous group, a group both envied and hated – those with money. In tough economic times, however, the issuers of bonds embrace anyone who can buy their bonds, including the less-affluent. This tendency was illustrated in a recent *Wall Street Journal* article, [States Plead to Small Investors: 'Buy Bonds.'](#) Municipalities are wooing individual investors.

California, New York and Ohio, for example, have all established websites to attract and inform small individual investors about their bonds. Some states, like New York, New Jersey, Maryland, Tennessee, California, and – recently -- Illinois have even established a retail order period for their bonds, allowing individuals to purchase bonds before institutional buyers. Municipal issuers have taken to advertising their bonds on the radio and the web to reach these investors. For example, the Valley Transportation Authority of Santa Clara, California was seeking funding for a local project. An estimated 72% of its \$650 million bond offering went to retail customers, more than twice the usual amount. Given the notification and the chance to participate, individual investors did so. The local residents wanted the project and voted with their dollars by purchasing the bonds that would support it.

Taking away the tax exemption of muni bonds is also not in the interest of the federal government. In 2009 and 2010, states and other municipalities were permitted to issue taxable bonds, through the Build America Bond (BAB) program, supported by a 35% federal tax credit. The issuance of BABs substantially reduced tax-exempt municipal bond issuance, especially in the longer maturities. Non-traditional muni bond buyers, including pension funds and foreign investors, bought the BABs. Those bonds competed with Treasury, U.S. agency bonds and corporate bonds both nationally and, for some issues, internationally. If the tax exemption were to disappear and the municipalities had to compete with these other issuers without a tax exemption, it would substantially increase



the borrowing costs of the municipalities. It would also increase the cost of borrowing for other taxable issuers as the field of competition they faced became more crowded.

Other risks are overstated

Whitney discussed the post-retirement health care costs of public retirees as being an increasing burden, as well as the expansion of Medicaid. These costs, however – unlike pensions – are not binding obligations on the states and municipalities. Public retiree health care costs are renegotiable and may be modified. Medicaid costs can change as well.

The idea that the wealthy would sell all their bonds at one time, as Gundlach suggests, is farfetched. According to *The Bond Buyer*, current sales of munis were not coming from managed accounts, banks or insurance companies; it is mutual funds who were shedding the bonds. Individual investors who became spooked by bad news in the media and declining fund prices have engaged in their usual activity of buying high and selling low their fund holdings. Dumb money is selling and the smart money is buying. At the same time, municipal issuance during January 2011 was down 66% compared to last year.

We are being swallowed up by headline news, which is both good and bad. Bad news helps because we need change. The unions have fed at the public trough for so long that they would rather eat their young than give up what they have grabbed for themselves. They would rather see half the police and firefighters fired rather than give back senior members' benefits, as recently happened in Camden and Trenton, New Jersey. Without the headline news, there would not be enough pressure on the politicians to stop exchanging benefits for votes and emptying the public coffers in the process. Unions will have to decide if they are for all the workers or only the workers with seniority. Politicians will have to decide if they are for cost cutting or for maintaining the status quo.

Some governments are posting small victories against unions. Vallejo, California, after declaring bankruptcy and voiding union contracts, renegotiated its contracts with the unions. Richmond, California just won an important legal battle. After eight years, the courts approved its firing of 18 firefighters during a fiscal crisis in 2003. The union had claimed it was a violation of union contract and put the remaining firefighters at risk.

One of the great advantages of our political and economic system is that people can openly address problems and air dirty laundry. Commentators hoot and holler. Voters elect new representatives, dumping those like Philadelphia's City Council, who awarded themselves extra-juicy pension benefits. The newspapers and other media sources dig up the dirt and shed light on the messes.



Improved regulation is on the horizon

Reporting by local governments has been improving. The Municipal Securities Rulemaking Board (MSRB) has put in place a voluntary reporting system on its Electronic Municipal Market Access (EMMA) [website](#). EMMA is the official source for municipal disclosures and market data, and it contains reports of the economic conditions of issuers, delayed market data, and prospectuses, all in an easy-to-use format. Municipalities that provide more timely postings are going to be given points for their compliance that will be recorded on EMMA. This is not in place yet, but it is coming.

The MSRB will also be reining in financial advisors to the states. No longer, hopefully, will they be able to wear the hat of financial advisor – possibly recommending derivatives – and then put on the hat of underwriter and do the deal.

Another sign of change on the horizon is the current debate over bankruptcy for states, which two House committees are going to take up. The California State Treasurer does not want this option, and S&P says it will raise borrowing costs if the option exists. Whether any legislation materializes or not, however, it will put the spotlight on the costs of running the municipalities.

Adding to that pressure, according to a recent *New York Times* [article](#), Moody's is going to begin to add pension obligations to the mix when rating debt of the states. They will use the states' own reporting of that underfunding, which can be significantly less than actual underfunding, depending upon rate-of-return assumptions. That is similar to how they rate corporate and sovereign debt.

Moody's says the states with the highest total indebtedness are Connecticut, Hawaii, Illinois, Kentucky, Massachusetts, Mississippi, New Jersey and Rhode Island. Other states, such as California, New York and Delaware may fare better because, although they have a relatively large amount of bond debt, their pension obligations are more fully funded. Announcements like this should increase the pressure for change. In fact, Standard & Poor's just announced that Massachusetts has been put on a positive watch for an upgrade, citing cost cutting and improvements in the Commonwealth's management. State politicians are not happy to see their bond ratings drop and their cost of borrowing rise.

A battleship at sea turns slowly, but once it starts turning it is hard to stop. So it is with state and local governments. There will be some casualties along the way, but the governments, both large and small, will figure out how to rein in costs, become more transparent, and be more effective.



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