

December 2010

## ***MUNI BONDS - WHAT IS ALL OF THE NEWS ABOUT?***

Recently, there have been several articles and news reports regarding the risks associated with municipal bonds (munis), also known as tax-exempt bonds. The articles have been focusing on credit and interest rate risks. On Sunday night, Meredith Whitney, the banking analyst who correctly predicted Citigroup Inc.'s dividend cut in 2008, dramatically predicted on *60 Minutes* that muni bond defaults will total "fifty to 100 sizeable defaults" and "hundreds of billions" of dollars worth of defaults.

We wanted to take this opportunity to define these risks and discuss how we attempt to mitigate these risks in our clients' portfolios.

### **CREDIT RISK**

Credit risk is the real or perceived possibility that a bond issuer may fail to pay interest or principal in a timely manner. With the financial crisis that has struck this country, state and local governments have been struggling due to lower revenues from taxes. States and municipalities lag in the recovery historically since they need personal and business income to grow before their revenues grow. In addition, there are underfunded public pensions and underfunded health care costs that have not been clearly reported. All of these factors contribute to the potential for credit risk for muni bonds.

To address credit risk, Filomeno Wealth Management (FWM) uses municipal bond mutual funds rather than single bond holdings. By holding mutual funds, our clients are able to hold more bonds than a client could own individually. For example, many of our clients hold Vanguard Limited-Term Tax-Exempt Admiral fund (ticker VMLUX) that holds 1,406 bonds. Another major fund holding for our clients, Vanguard Intermediate-Term Tax Exempt Admiral fund (ticker VWIUX), holds 2,888 bonds. If one, two, or even 10 or 20 of these bonds are unable to pay interest or principal, it would only be a small fraction of the total holdings.

Another way FWM addresses credit risk is by reviewing the credit quality of the mutual funds. By selecting funds with higher credit quality bonds, the risk of default is reduced. Vanguard Limited-Term Tax-Exempt Admiral fund and Vanguard Intermediate-Term Tax Exempt Admiral fund have 70.56% and 78.94% of their holdings in AAA or AA bond holdings, respectively, the top two ratings by Standard and Poor's. In addition, they each have less than .1% in bonds with ratings of BB, B or below B, the lowest 3 ratings by Standard and Poor's.

Finally, Fitch Ratings published a special report titled "U.S. State and Local Government Bond Credit Quality: More Sparks than Fire" dated November 16, 2010 that states, "The 10-year-cumulative default rate through 2009 for all rated municipal bonds, including those rated below investment grade, ranges from .04%-.29% based on reporting from all three major rating agencies." They add that debt service is

a small part of state and local government's budgets, generally less than or significantly less than 10%, and there would be significant cost to not servicing the debt.

### **INTEREST RATE RISK**

Interest rate risk is the chance that bond prices will decline because of rising interest rates. During the past 2 months, bond prices have been falling due, in part, to the increase in supply. Thomson Reuters actually reported that municipal bond volume hit a record of \$424.8 billion as of December 21, 2010. The increased volume is largely due to the spike in Treasury yields and the non-renewal of the Build America Bonds (BABs) program. The Treasury yields spiked in reaction to the Federal Reserve's second round of quantitative easing (QE2). Muni yields followed Treasury yields so bond prices dropped. BABs are taxable bonds subsidized by the government created as a temporary measure in 2009 as part of the stimulus act. Since it was unclear whether the BABs program was going to be extended as part of the recent Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, there was a spike in municipal bond issuance.

To address interest rate risk, Filomeno Wealth Management monitors duration, which is the measure of the sensitivity of price to a change in interest rates. For example, if duration is 2.5 and interest rates increase by 1%, the value of the principal will decrease by approximately 2.5%. The Vanguard Limited-Term Tax-Exempt and Vanguard Intermediate-Term Tax Exempt funds have durations of 2.53 and 5.59, respectively. By keeping duration low, the principal value will decrease less than if duration is high in a period of rising interest rates.

### **SUMMARY**

In summary, no investment is risk-free. It is important for investors to be aware of the risks of any investment. Muni bonds are one tool in developing an appropriate asset allocation for our clients in their taxable accounts. Muni bonds are subject to credit risk and interest rate risk. To address credit risk, FWM uses high quality mutual funds. To address interest rate risk, FWM currently uses funds with lower duration. By considering the risks and attempting to mitigate them, muni bonds remain an important asset class in our clients' portfolios.

Please do not hesitate to call us if you would like to discuss this issue further.