Chasing Muni Yields Carries Risks

by Aleksandra Todorova
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MUNICIPAL BONDS, let's face it, could make anyone snooze. "They're complicated and boring," says Donald Cummings, principal of Blue Haven Capital, a fee-based wealth-management firm in Geneva, Ill. When he brings up the subject at cocktail parties, he says, people walk away.

These days, Cummings may find it easier to grab listeners' attention. Over the past two months, municipal bond yields have consistently exceeded Treasury yields, even before factoring in the tax advantage. As of May 7, 30-year Treasurys yielded 4.61%, while AAA-rated (the highest credit quality) municipal bonds of the same maturity hit an average 4.88%. Since interest earned on munis is tax free, that's the equivalent of a taxable investment yielding 7.3% for someone in the 33% tax bracket, or 6.5% for someone taxed at 25%. Shorter-maturity Treasurys were also close, or lower than AAA-rated munis on a pretax basis, while munis rated AA or lower exceeded Treasury yields on all fronts. "I've been in institutional trading and sales of municipal bonds since the late 1980s and I've never seen such a run," says Cummings. "Never all through the curve and never for so long."

Normally, municipal bonds yield less than Treasurys, with the tax-free interest making up the difference for investors in the highest tax brackets. But the credit crunch and concerns with bond insurers' downgrades caused many institutional investors to sell off munis and other securities not guaranteed by the government. "There was a flight to quality in the past 12 to 15 months where investors sold anything with risk and bought Treasurys," explains Scott Berry, senior fund analyst with research firm Morningstar. The selloff suppressed muni prices and, consequently, pushed yields up. Increased demand had the opposite effect on Treasurys.

As a result, investors as low as the 25% tax bracket may be compelled to shift a part of their fixed-income portfolios to municipal bonds. And given the paltry returns of money-market funds and savings accounts these days, munis may even sound like a good place to park your extra cash.

For most investors, however, the risks outweigh the returns. "Right now the yields look fantastic and juicy, but they're juicy for a reason," says Michael Boone, a fee-only certified financial planner in Bellevue, Wash.

Housing-bust spillover

Thanks to low default rates, municipal bonds have historically been considered extremely safe. But the weakening economy and plummeting housing prices have put the health of some municipalities at risk, raising questions about their ability to repay debts. "The overall feeling is that as the economy weakens, a lot of these municipalities may not be in good shape, so there's a fear that their credit quality may decrease," says Boone.

If a municipality relies largely on collecting real estate taxes, for example, falling property values would cut into revenues - a problem that many municipalities have not had to deal with in recent history. Just this week, the Northern California city of Vallejo declared Chapter 9 bankruptcy, allowing it to continue providing services while freezing its debts. When a municipality declares bankruptcy, the bond insurer would typically take over payments of principal and interest, Boone explains. But should the number of such bankruptcies increase, investors now question the ability

of insurers to take over the financial burden.

Hence, the importance of location, Boone warns. "A real estate-led decline, unlike other struggles in the economy, is very much localized. When we build a portfolio for clients, we consider geographic diversification just as important as maturity diversification and credit diversification."

For a combination of high yields and safety, Cummings recommends pre-refunded or escrowed-to-maturity bonds. These are bonds that municipalities have refinanced into Treasurys at some point in the past to take advantage of lower interest rates. Since they continue making the original coupon payment, investors get higher yields for a security backed by the government.

Liquidity concerns

Municipal bonds trade infrequently, which makes pricing difficult, says Jeff Tjornehoj, research manager at financial research firm Lipper. "Your broker may buy it from you and execute the trade as quickly as possible, but if the last bond sold six months ago, how do you know [you're getting] the right price?" A lack of buyers could mean that you take a hit on your original investment.

That makes buying individual bonds with your emergency cash a bad idea, says Gary Schatsky, a fee-only certified financial planner in New York. "An emergency fund is something you could liquidate right away without having your arm cut off," he says.

Inflation risk

With yields exceeding 4% on AAA-rated bonds, those 20- or 30-year munis may be hard to resist. But locking your money in for a long period of time in today's low-interest-rate environment exposes you to inflation risk. "A lot of people say if you hold a bond to maturity you have no risk, but that's a lie," Schatsky says. "If you're getting 5% for 20 years and everyone else is getting 6% for 20 years, you're kidding yourself if you think you're not losing money."

Steve McLaughlin, director of business analytics at Municipal Market Advisors, recommends three- to five-year bonds. Faced with lack of demand for so-called adjustable-rate securities, or long-term bonds with floating rates adjusting every seven, 28 or 35 days, municipalities are now forced to restructure them into bonds that mature in three to five years. That causes an oversupply that suppresses prices and, therefore, increases yields, McLaughlin explains.

Hidden costs

Individual bonds are purchased through brokers, whose commissions can be exceptionally high, Schatsky says. That's why he warns investors with less than $100,000 to spend to stay away from individual bonds. "For more modest purchases, I am inclined to look at no-load, low-cost, diversified muni bond funds," he notes.

Morningstar's Berry recommends looking into the tax-exempt funds offered by Vanguard, Fidelity or T. Rowe Price. "You get really good management and low cost," he notes. But don't expect impressive yields: The average municipal bond fund has actually lost 1.31% year-to-date, according to Lipper.

Cost-conscious investors may also look into muni bond ETFs, such as the **iShares S&P National Municipal Bond** (MUB: 100.95, +0.12, +0.11%) or **State Street's SPDR Lehman Municipal Bond** (TFI: 22.02, +0.10, +0.45%) funds. Since they track an index, ETF yields are also on the lower side, McLaughlin says. For many investors, however, the pros - lower costs, liquidity and diversification - may outweigh the cons.