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REGISTERED INVESTMENT ADVISOR

Market Insights

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Managing Municipal Market Credit Risk

Our process for managing credit risk in individual municipal bonds goes well beyond the credit ratings that they are assigned by credit rating agencies. While we believe these ratings have value, and they are one piece of information we consider, we also evaluate other parameters such as the bond issuer's municipal market sector, municipality revenues and financials.

Since the recession that began in December 2007, many investors have become more and more concerned about default risk in the municipal market. Recent decisions by three California municipalities — Stockton, Mammoth Lakes and San Bernardino — to move forward with Chapter 9 bankruptcy filings have led to more questions about the health of the municipal bond market. We, however, continue to emphasize that the vast majority of municipal bond issuers are in good health and fully capable of meeting their principal and interest payments. Our credit standards, which are outlined below, help us mitigate default risk in municipal bond portfolios.

There are five key elements to our process: assessing the underlying rating of the issuer assigned by Moody's and Standard and Poor's, determining the bond issuer's sector, reviewing the annual revenues of the issuer, analyzing information obtained through Bloomberg on issuer financials and current news, and assessing the credit risk the market assigns to the bond. Let's briefly describe each step we take:

1. **The underlying issuer must be rated either A, Aa or Aaa if the security has less than three years to maturity and Aa or Aaa if it has three or more years to maturity.** Note that we focus on the underlying issuer's rating and not the "insured" rating. This strategy has helped us more effectively manage credit risk in client portfolios because the insurance companies that have historically insured municipal bond default risk were largely crippled by the subprime mortgage market meltdown, essentially making the insurance worthless in many cases. The purpose of this ratings screen is twofold. First, despite the bad press that rating agencies have received, nonrated bonds have historically defaulted at much higher frequencies than rated bonds. Second, the diversification benefit of fixed income tends to decrease as you move from Aaa down to lower ratings.
2. **We require that the bond is from either the general obligation or essential service revenue sectors of the municipal market.** These two sectors historically have had much lower default rates than other sectors such as health care and housing municipal bonds. For example, from 1970–2009, Moody's reports that there were 54 defaults on municipal bonds that it had rated and only three of those were general obligation bonds.[1] The bulk of the defaults were from the health care and housing sectors, which are sectors that we do not buy.
3. **For general obligation bonds, the issuer must have at least $50 million of annual revenues.** The purpose of this screen is to reduce exposure to smaller municipalities that generally have less ability to maneuver through difficult times. They also are more sensitive to outlier events such as large lawsuit judgments that may be easier for larger municipalities to manage.

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4. **We use Bloomberg's data services to analyze the municipality's balance sheet, access relevant ratings reports and read any current news on the municipality.** This helps us understand the rating agency's perspective on the municipality and whether there are any financials or news that leads us to believe the agency rating is overstating the credit quality of the issuer.
5. **Before purchase, we compare the yield on the bond we are considering with yields on the highest-quality municipal bonds.** We refer to this as the "market test." A hypothetical example should help clarify the value of this step. Let's say we know a five-year municipal bond of the highest credit quality is yielding 2.0 percent. If we are considering buying a municipal bond that satisfies all the other criteria but it is yielding 4.0 percent, this indicates to us that the market is pricing a lot of risk into this bond, so we will generally avoid purchasing these bonds.

A municipal bond is eligible for purchase once it has met these five criteria. While this process does not ensure that we will avoid all defaults, we believe it greatly reduces the likelihood of a bond default. In practice, we have never had a default on a municipal bond that we have purchased, which speaks to the value that the above process has provided to our clients.

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[1] Moody's Investor Service, **U.S. Municipal Bond Defaults and Recoveries, 1970–2009.** February 2010.

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