

Investment Focus

General Safety of Municipal Bonds



In our current environment, certainly all nature of investments — including municipal securities — face some distinct and significant challenges. To understand and proactively address these challenges, we will continue to apply our rigorous research process in analyzing municipal bonds. We remain confident in the role municipal bonds hold in the market overall, and in our client portfolios. We hope that this background on the fundamentals of municipal bonds and their strength in this particular market cycle proves useful to our clients.

When assessing the risk of municipal bonds in the current economic times, it is important to keep the essential nature of municipal bonds in the forefront of one's thought process. The following questions may help to provide perspective.

- How are intrastate roads built and maintained?
- How do we fund our public transportation infrastructure — subways, buses, and trains — that enable the American way of urban life?
- How do we pay police and firefighter salaries during certain low cash inflow months?
- How, in certain areas of the country, do we ensure electricity is reliably transmitted to our homes and businesses?
- How do we maintain and update our airports?
- How do we build the facilities that ensure we can safely and cleanly dispose of our municipal sewage?
- How do not-for-profit hospitals maintain and update their facilities?

The answer to all these questions is, either completely or substantially, through the municipal bond market. *Municipal finance is literally the financial backbone of the American system of government.* The financing of all the functions noted above is an unquestioned priority of the federal government. Should there ever be a need, we believe that the federal government will take whatever steps are necessary to stabilize the municipal markets. Period.

Current Challenges

It is true that municipal governments are experiencing greater pressures than they have faced in recent years, as is true for most other segments of our society these days. Let's identify some of those pressures. Sales taxes, an important component of most state government financing, are likely to fall as consumers reduce spending. Fewer houses are selling, reducing real estate transaction revenues to cities and towns. Higher energy costs put pressure on governments' budgets. Corporate tax revenues likely will decline in the short run. Governments for the first time are being required to come up with long-term funding programs for their retiree health benefits; in the past, these had been funded every year, as needed. Personal income growth may decline. Public employee salaries seem to go up a little every year regardless of the economy.

These budgetary pressures seem to present a grim picture, and some municipalities surely will experience ratings downgrades in the future for these reasons. Despite these challenges, we believe the entities backing municipal bonds will remain very safe investments, well able to make their scheduled and timely payments on interest and principal. This belief is based on several important facts:

I. Municipalities go into this period of weakness with strength, having improved their credit status measurably in recent times.

Credit ratings of municipal bonds are very high relative to other types of bonds. Consider Fitch Ratings Service’s average ratings for the “governmental” sector. This is the largest and most important of municipal bond issuing sectors. On Fitch’s ratings scale of AAA (best) to D (worst), the types of bonds within the “governmental” sector rank very highly relative to other types of bonds. Note the following average ratings: state general obligation: AA, local government general obligation: AA-, and water/sewer: A+.

In addition, consider credit trends. Upgrades have vastly outnumbered downgrades recently; in fact, *upgrade-to-downgrade ratios have been at record levels*. For example, according to Standard & Poor’s, municipal bond upgrades outnumbered downgrades 13.9 to 1 for the first half of 2008. The numbers were even better in the second quarter than in the first. In Q1, upgrades outnumbered downgrades by 6.9 to 1. In Q2, the ratio rose to 22 to 1. The number of upgrades this year is by far the largest since at least 1986. For the ever-important “governmental” sector, the results are even better. In Q1, upgrades outpaced downgrades 11.5 to 1. In Q2, the ratio was an amazing 62 to 1.

What does S&P say about these trends? Despite some negative news that we noted above, S&P “believes that most states will continue to be well-positioned to manage their budgets thanks to reserves accumulated from fiscal 2005-2007.” What about local governments? “Overall, credit

quality for municipalities and school districts remains quite strong, despite challenges looming on the horizon. Revenues and fund balances are up, and financial management has improved. Governments may now find themselves better positioned to deal with any declines in revenue due to an economic downturn.”

In summary, municipalities have high ratings and have strengthened themselves leading into the current period, a big help when facing some negative headwinds.

II. The default rate for municipal bonds historically has been extremely low.

How many municipal bonds default? Let’s look at a portion of Standard & Poor’s cumulative default rate table for the years 1986-2007, the most recent data available, and compare it to the corporate default rate.

The numbers show the percent defaulting. The first number, **in bold type**, in each box shows the municipal default rate (1986-2007). The second, not bolded, numbers show the corporate default rate (1981-2007) for comparison. For example, three years after being rated A, municipal bonds had a cumulative default rate of 0.01%, or one in ten thousand. Corporate credits had a cumulative default rate of 0.30%, or 30 in ten thousand.

| Rating Category | After 1 Year | After 3 Years | After 13 Years |
|-----------------|------------------|------------------|------------------|
| AAA | 0/0 | 0/0.9 | 0/0.67 |
| AA | 0/0 | 0/0 | 0/1.03 |
| A | 0/0.07 | 0.01/0.30 | 0.07/2.26 |
| BBB | 0.01/0.23 | 0.08/0.85 | 0.28/5.93 |

This table demonstrates both the very low rate of municipal defaults and the low rate relative to corporate credits for a historical period of at least 20 years. These numbers clearly point to the relative safety of municipal bonds.

III. Municipal bonds have some unique, built-in strengths.

Compared to other types of bonds, municipal investments possess several fundamentally different characteristics that should provide some reassurance, despite this challenging environment:

- States are practically sovereign entities that can tax *as much as they deem necessary* to pay costs such as debt service.
- Most municipal bond issuers face *limited or no competition*.
- Local governments, as well as states, provide services such as police, road repair, and education that are *absolutely required by our society*.

For local governments this means that, if they face economic difficulty, higher levels of government (county, state and federal) have some large incentives to provide assistance. We have seen some instances where financial control boards have been implemented by states for troubled local or city governments, such as Philadelphia, that have asserted control over finances and rectified the problem, resulting in credit upgrades for bonds. *The capacity and willingness of higher levels of government to step in to help local government entities in difficulty should not be underestimated.* It hasn't happened too often because local governments do not often get into that level of difficulty, but it is a tested and successful means of restoring stability.

- The *legal security enjoyed by the municipal bondholder is often very powerful*. Most state and local debt carries a "general obligation" pledge. This means that the "full faith and credit" of the issuer backs the bonds, including taxing power and sometimes a first lien on pledged revenue. For municipal utility, water/sewer, and toll road bonds, issuers normally have *full rate-setting autonomy* for their services. They usually

make a covenant with bondholders, committing to charging rates for their services that will in all cases meet or exceed debt service requirements.

- Municipal bond issuers have the power to *enforce revenue collection*. If a user does not pay a water bill, the water can be shut off, providing a powerful incentive to pay.
- Unlike other types of issuers such as corporations, almost all municipal issuers will continue to exist in perpetuity. If a municipality ever had a debt repayment problem, the issuer would continue to exist as a vibrant, cash flowing entity during and after the problem. Due to the perpetual nature of the issuer, *bondholders benefit from a myriad of potential solutions to problems that would not be available if the issuing entity ceased to exist due to its financial difficulty*.
- *The financial statements and reserves of municipal issuers contain special benefits to bondholders*. Often bond documents require a debt service reserve associated with a bond issue. These reserves are set aside legally for payment of bond debt service and cannot be used for any other purpose. In the good times of the last few years, many municipalities have created or added to "rainy day funds" -- funds that can be drawn down in more challenging times. Municipal accounting allows the "General Fund," the fund that usually pays debt service on bonds, to borrow from other funds of that same municipality to pay debt service. For example, if a city were running short in cash temporarily, that city could borrow from its municipal light fund or other such fund in order to pay debt service. Real estate assessed valuations often are averaged over a period of years. As a result, during a downturn in valuations, a home's assessed value will fall more slowly than the market value, leading to steadier valuations for the municipality.

IV. Payment of debt service on bonds is a priority expense for issuers.

The above statement is true in two senses. First, it is often legally stated as such. For example, in its upcoming note issuance, California has designated debt service to be a “priority payment,” equivalent to a few key categories such as educational and state employee salary expenses that are deemed more essential and thus prioritized over other types of expenses.

Secondly, municipal bond buyers demand timely payment of debt service. Should an issuer not make a payment on time, that issuer might easily lose access to the bond market. No one will buy that issuer’s bonds. All municipalities need to issue bonds to an extent to fund their costs. Not having access to the bond market is simply not an option. The incentive to maintain bond market access is very, very powerful for all municipalities.

Given the current dislocations in the market, the importance of having a rigorous analytical process that can uncover value for our clients is only heightened. At BNY Mellon Wealth Management, we do not purchase bonds based solely on ratings or bond insurance. We base our buy and sell decisions on the fundamental characteristics of the issuing entity.

In addition to an in-depth research and analytical approach, we believe that experience, including a sound professional educational background, is a major factor in good credit judgment. Each of our analysts has at least 18 years of experience as an analyst and each has covered a variety of sectors. Our municipal bond analysts all have worked together as a team for more than ten years at BNY Mellon, ensuring a system of researching credits that has been tested and proven over time. All analysts have achieved the Chartered Financial Analyst (CFA) designation, an important credential in the investment management industry. All also have either an additional advanced degree or have been credit trained at one of the two largest credit rating agencies in the world. The quality of these professionals, coupled with the quality and discipline of their research and investment orientation, helps to ensure an investment portfolio that can withstand even challenging market environments.

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Art is director of credit research for BNY Mellon Wealth Management. He is responsible for the credit quality of individual client and mutual fund fixed income portfolios. He also is the chairman of the Fixed Income Asset Review Committee.

Art has more than 20 years of investment experience and joined the firm in 1991. Art was part of Mellon’s workout lending group in 1991 before joining the fixed income group as a municipal analyst in 1992. Prior to joining the firm, he was a credit analyst and a lending officer at Bank of New England.

Art received a bachelor’s degree from Harvard College in 1982 and a master of business administration from the Darden School at the University of Virginia in 1987. He is a CFA charterholder and a member of the Boston Municipal Analyst Forum.