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MUNICIPAL BONDS: TRIPLE AAA OR AAA-LARMING?

FEAR IN THE MUNI MARKET

The panic and recent sell-off in the municipal bond market that began in November 2010 and ended largely at the end of January 2011 wiped out all of the net purchases experienced in the first 10-months of 2010. What caused this panic? Supply and demand? Expiration of the Build America Bond program? Deterioration in credit quality? Investor fatigue? It stands to reason, if a country like Greece can nearly default on its debt, why can't California, Illinois or any other state grappling with budget deficits do the same?

Unfortunately, much of the media attention and analysis seems to view the entire municipal bond marketplace as single, vast and troubled sector. According to the Municipal Securities Rulemaking Board, there are more than 60,000 individual state and local government, district and other issuers active in the municipal bond market with nearly $3 trillion in debt outstanding. Roughly half of the municipal market consists of government "General Obligation" (GO) or other tax-based bonds, while the remainder are revenue bonds. Only 54 defaults have occurred since 1970—and only three were GOs (none in MN).[1]

Unlike the U.S. Government, local governments and states are restricted from running budget deficits or funding those with long-term debt. Moreover, current budget troubles are not a debt problem. The current average percentage of state and local budgets dedicated to paying bonds or debt is between 3% and 5% of their annual budgets, which means they have little to gain by defaulting on their bonds. States and municipalities are permanent government entities; not corporations. Unlike companies, state and local governments cannot simply go out of business. Any default would seriously damage a state or municipality's reputation and increase the future cost of borrowing. That's why states and municipalities avoid defaults and close budget gaps with lower expenditures and higher taxes (e.g. Illinois recently raised its state income tax to 5% from 3%).

WHAT THIS MEANS FOR YOU

There are many good reasons why we hold municipal bonds. We have found that high-quality, intermediate-term municipals (taxable and tax-exempt) have better liquidity and capital preservation than lower-quality municipals. High-quality bonds also tend to have higher cash-flows than dividends which may be used to supplement income or provide buying opportunities for additional securities.

Here are a number of ways Compass limits the risk in our bond portfolios;

1. **Stick with quality**. We buy/hold highly-rated bonds only;
2. **Know what you are buying**. We use intermediate-term bonds only (1-10 years), which historically have been less volatile than longer-term bonds;
3. **Monitor your holdings.** We hold bonds that maintain a high credit rating and do not simply rely on insured bonds. Muni bonds come in a wide-variety of types and their creditworthiness is often difficult to analyze.

At Compass, we invest in high-quality, intermediate-term bonds only in our portfolios. We have used recent events to look for relative value between sectors—U.S. Treasury, corporate and municipal markets. For example, top-quality Minnesota tax-exempt municipal bonds have recently provided similar yields to those of U.S. Treasury bonds. Buying municipals has been a good way to add value for our clients.

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1. "U.S. Municipal Bond Defaults and Recoveries, 1970-2009". Moody's Investor Service. February 2010.

For more information regarding our company, disciplines and results, please call, write, e-mail or visit our website: www.compasscap.com

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