

Munis and The Big Reset

The search for new ways for states and cities to shore up their finances helps create uncertainty—and opportunity—for municipal bond investors, says Adam Stern of Breckinridge Capital Advisors

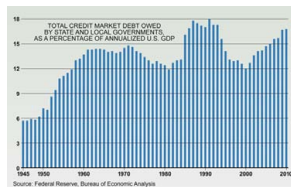
STERN'S KEY INSIGHTS

- ▶ An emphasis on cutting spending rather than raising additional revenue bodes well for the muni market
- ▶ Investors may find good opportunities in issues for water and sewer systems and some toll roads and airports
- ▶ Good health-care opportunities are out there, but the sector includes some stressed credits

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Large deficits and comparatively sparse tax revenues are forcing state and local authorities to seek creative ways to get and keep their fiscal houses in order, a process dubbed The Big Reset in a February 2010 policy paper by the National Governors Association Center for Best Practices. Concerns about the prospects for success—and the consequences of failure—in this endeavor have stressed the municipal sector, notes Adam Stern, senior credit analyst at Breckinridge Capital Advisors. The muni landscape is riskier than it was a few years ago, he acknowledges, but not as dire as many fear. He believes that investors and Financial Advisors are underestimating the likelihood that The Big Reset experiments will work. "Municipal bonds have been a little beaten up, as we see the austerity battle play out," Stern observes. "The battle makes people nervous, and that [helps] create opportunities."

Skirmishes have been fought lately on several fronts in the Midwest, where often-acrimonious debate has focused on pay and benefits to public employees and obligations to retirees. "People who invest in municipal bonds are looking at city and state governments and asking how they're going to make ends meet," Stern says. In his view, what's important, and likely to help the muni market, is that public officials have been addressing the same question more urgently.

This is where The Big Reset comes in. Among the approaches intended to balance the books, or at least close the gap between both sides of the ledger, Stern says, are raising tuition and reducing subsidies at public universities, privatization of state and local services and stressing cost effectiveness in matters ranging from setting prison terms to approving infrastructure projects. "Policymakers are implementing reforms that were politically untenable in prior budget cycles," he says. "Ideas about how to restructure spending and tax more efficiently have been around for a while. We are now seeing these ideas being put into practice." It's an especially hopeful sign, Stern adds, that officials are concentrating on cutting costs rather than on raising additional revenue.

Less competition for investors' money and an emphasis on essential services should help underpin munis, Stern believes. He recommends that some investors and FAs focus on higher-grade issues, those rated A or above by Fitch and Standard & Poor's.

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He finds "plenty of high-quality general obligation bonds, even in states with problems," and for several sectors, he likes revenue bonds, which finance specific projects and are repaid from the fees they generate. These include water and sewage plants and some toll roads and airports. Stern is more selective on hospitals, though. "Good health-care opportunities are out there, but the sector includes some stressed credits."

Investors appear anxious about The Big Reset, Stern says, because it's too early to tell how effective some of the initiatives will be. But, he contends, governments' financial well being is not as shaky as some suppose. Many jurisdictions have "systems in place that are time honored and time tested," he points out, citing localities' requirements for balanced budgets and voter approval for issuing debt. His research, based on data compiled by the Federal Reserve and the U.S. Bureau of Economic Analysis, shows that the level of municipal debt, at 16% of the nation's economic output, is "well within the range of the last 30 to 35 years." He also cites analysis from Bloomberg indicating that the average state or local pension plan has 13 years of benefits on hand, leaving considerable time to avoid shortfalls.

Stern takes heart from the signs of a fresh resolve to shore up public finances with a mix of new and traditional approaches, and he believes that investors will come around soon. "People are right to assume that there's elevated risk in municipal bonds relative to five or six years ago, but there's a larger recognition of what the issues are," he says. "There are people who have a sense of what the solutions might be. Now the big question is implementation."

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