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Dotards Unite!

Defending the Diversity and Benefits of Munis

Baird Funds

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The municipal bond market has at times been described as the Rodney Dangerfield of the financial markets – it gets no respect. A recent example, a Forbes article titled "Munis for Dotards," caught my attention due to its particularly aggressive criticism, not just of municipalities, but also of those who manage municipal debt. The author accused municipalities of "lying to people" about the shortfall in their unfunded liabilities. He claimed that muni bond managers have "limited capabilities" in analyzing the true fiscal condition of municipalities, particularly as it relates to a very large pending borrowing by the "hopelessly corrupt and insolvent state of Illinois." If only "these dotards" would "stretch their little minds," he posited, they would be able to remember their mistakes from the past and avoid repeating them. As the late Mr. Dangerfield himself would say, "No respect, I tell ya."

Speaking of past mistakes, consider the December 2010 60 Minutes interview with another muni market outsider, analyst Meredith Whitney. You may recall the unwarranted and uninformed shot at the municipal market, warning of "… 50 to 100 sizable defaults, more. This will amount to hundreds of billions of dollars' worth of defaults"? Seven years later, muni defaults remain rare, and the financial condition of the vast majority of municipalities is significantly better than in 2010.

Among Ms. Whitney's misjudgments was not appreciating the diversity of credits in the municipal market. There are an estimated 80,000 different municipalities across the country, each unique. If 80,000 fans were packed into a football stadium, surely there would be some who are wealthy and others who are struggling financially. Just as it would be unfair to make generalizations about the financial condition of all 80,000 fans, it's equally unfair to do the same with all municipalities.

Yet, here we are again reading alarming generalizations implying that the entire municipal market is in dire financial shape, its woeful state abetted by an assemblage of feckless dotards.

Dotards Я Us

As one of those municipal managers with allegedly limited capabilities, I'll confess – I had to look up "dotard"– "An aging individual who has long lost the ability to make rational sense." Realizing that I may qualify – at least to the aging part – and feel compelled to rally my fellow muni dotards to unite! and defend the municipal market we labor in every day.

However, rather than argue that the pension challenges some municipalities face aren't real–they are – I wanted to help both dotards and non-dotards alike appreciate the fact that muni investors have options. In fact, it's very possible to build and manage a large, diversified municipal portfolio while also minimizing pension-related risks. How?

Pension-less Muni Options

Some dotards I know, and as it turns out I know quite a few, buy U.S. Treasury and Agency debt disguised as municipal bonds. These are bonds that are pre-refunded to a call date or escrowed-to-maturity, with sufficient funds set aside to repay the debt. The funds are invested in U.S. Treasuries and/or federal agency bonds which are held safely in escrow. Some may question the wisdom of lending money to the U.S. government, but until a safer alternative is found, my money is with Uncle Sam. Buying U.S. government-backed municipal debt is safe and provides tax-free income to the muni investors who do.

Dotards have also been known to purchase municipal bonds issued by state housing authorities. These are agencies of the states that issue debt backed by pools of single family mortgage loans. Most, and in some cases all, of the mortgages in the pools are also federally guaranteed, and the mortgage pools are typically overcollateralized relative to the amount of debt issued. They are strong credits, which also promote first-time home ownership and affordable housing options for the resident of their states.

Some dotards buy essential service municipal bonds backed by a specific revenue stream, like transportation revenues – airports, tollways, mass transit systems and the like. Users of these systems pay fees as they travel more efficiently and economically around the country. Other dotards have grown soft in their old age, even relying on modern luxuries, such as electricity and clean, accessible water. Local and regional utilities issue debt backed by the monthly/quarterly bills we pay. If revenues are insufficient, a utility board implements a rate increase without a referendum. If a customer refuses to pay, the service is cut-off. It's a pretty simple choice, and it has been my experience that people pay. It beats the alternative of drawing water from a backyard well, running to the outhouse, and stumbling back inside with a flashlight!

Dotards occasionally get sick, and when we do, we appreciate having a hospital or clinic close-by. There is a two-in-three chance that the healthcare facility we visit will be a nonprofit provider, which has borrowed money in the municipal market to finance the very facility we use. The debt is repaid through a mixture of private, commercial and government reimbursement. Healthcare providers are often among the largest employers in their communities; large employers that offer defined contribution plans, rather than pensions.

Dotards also have children, and if they're lucky, grandchildren, who are educated in municipal financed classrooms. The vast majority of this debt is repaid through local property taxes which must be paid or the home or business owner forfeits the property. It's a very strong source of revenue. Even dotards who were taught in a one-room schoolhouse are likely able to evaluate the prospects for repayment based on the economic strength of the local community. If public school debt is too risky because of concerns over the teacher pensions, there are many private schools and charter schools that also issue municipal debt. After graduation, there is a good chance every college, public or private, to which the student applies will also have issued municipal debt. Dotards win by buying the debt and junior gets a great education.

Munis – Good for You and Your Community

Hopefully, it's apparent by now that not all munis are created equal. And even if they were, like humans, municipalities change over time. The changes, however, are typically gradual, evolutionary, affording dotards many opportunities to decide, even with their "limited capabilities," if the risk/reward tradeoff is in their favor. If after the assessment it seems skewed in the wrong direction, then move on. There are thousands of other bonds to choose from. Each dotard can be as aggressive or as cautious as suits their investing comfort level. But no one should let the naysayers keep them from doing good both for their portfolio and their community by investing in muni bonds.

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