Stamper Capital & Investments, Inc.

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Are Your Municipal Bonds Safe?

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How do you know if your hard earned savings invested in Municipal bonds are going to stay with you through the rest of the financial crisis? Can you tell if your Advisor placed you in riskier lower quality bonds in hopes of higher performance returns, or did your Advisor buy relatively safe generic bonds to preserve liquidity? Better yet, has your Advisor planned ahead and placed your money into the absolute best, top-quality muni bonds, though giving up some return, to put you into a position of strong buying power in anticipation of another big market crash? In this brief article, Stamper Capital & Investments, Inc. will share some of our expertise in the municipal bond market to help you find out for yourself if your Advisor is buying bonds that have the ability to weather the financial storm our Portfolio Manager, B. Clark Stamper is predicting (read about it in his 2011 Annual Forecast on our website, www.risk-adjusted.com) – and no, he absolutely does not think the worst is past us, quite the contrary, the financial roller coaster ride has only just begun.

Most investors seem to think that if you've seen one muni bond you've seen them all. That couldn't be further from the truth. After all, a municipal bond is actually a loan to a government entity, and all we know that cities, counties and states are not created equally and can miss payments. In fact, as we shall see, sometimes even two bonds from the same issuer can have completely different levels of risk. What is paramount when thinking of a bond, is that investors should replace the word 'bond' with 'loan', and try think in terms of "I am lending my money to this city – do I think they will be able to pay me back? Is the amount of interest they are paying me worth the risk that I will not be repaid? What happens if they run out of money before my principal is returned?"

Probably the first thing many investors look at is the credit rating on a bond. While credit ratings might be a good general indicator of the quality of your portfolio, they are not infallible, and are certainly not a be-all end-all. In actuality, the majority of credit downgrades occur AFTER the fact – after a poor annual financial statement, after a missed bond payment, after a notice of default is issued. Once your bond is downgraded, that's it, you have lost some liquidity, and you might not be able to sell it at breakeven if you want to unload it. The important thing is to have your own sense of how you think the economy is headed, and plan accordingly. Trust your own gut instincts – keep in mind that the credit rating agencies get paid by the very people (municipalities) who they are rating, so there is always a conflict of interest!

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Many bond issuers will choose to bypass the hassle or expense of getting their own credit rating (or need a boost to their own credit rating) by buying bond insurance and taking on the credit rating of the bond insurer instead. While this used to add some security value to bond, it isn't all that important anymore, as most of the major bond insurance companies are in a state of winding-down their business after losing a fortune when the CDO and sub-prime markets collapsed in 2007/2008. The insurers, who used to have triple-A credit ratings, are now basically junk-rated (incidentally, they were not downgraded until AFTER the insurers themselves announced how much of their insurance funds they lost on bad investments). If your bonds still have insurance, that is great, but don't rely on it to pay 100%, or even 50% of your claim if the guarantor goes bankrupt.

Occasionally you may hear about cities, counties, or other municipal entities claiming bankruptcy. This poses a very real risk to bondholders, depending on the level of collateral pledged to their loan, as well as the seniority, or structure, of the municipal finances. If your bond has a 1st lien on some collateral, then in bankruptcy court, you are first in line to be paid from that collateral. For example, if your bond is backed by a 1st mortgage on a nursing home facility, when that facility is sold in bankruptcy auction, you are 1st in line to be paid, hopefully up to 100% of your claim, before anyone else with a lesser claim than yours. Even better, if your bond is backed by an escrow account full of US Treasury Strips, your bonds probably wouldn't even need to be paid off in bankruptcy – they could go on business as usual, while you collect your tax-free income year after year until maturity. This could be an interesting situation if, suppose, a City goes BK. Unsecured bondholders might be paid 30 cents on the dollar, but holders of Escrowed bonds probably wouldn't even miss a coupon payment!

Of course, one would hope that the municipality would not have to go bankrupt in the first place! Here is where you would want to know where the source of bond payments is coming from – a claim on a solid stream of revenue is the backbone of a good bond investment. A typical State General Obligation bond, for example, would be paid by all (legally available) revenue coming into the State's General Fund before anything else is paid (this depends on the State Constitution - California, for instance, pays Education costs, then bond payments, then everything else, but this is not the norm), which is why most state bonds are a well respected investment. A Sewer bond would typically be paid from all revenue net of minimum operating costs to keep the sewer system running. A mortgage bond is paid from the homeowner's mortgage payments. You can see where some streams of revenue can be more solid than others.

All in all, it is good to know what investments you are holding – even if it would just help you sleep sounder at night. Too many people think muni bonds are all the same. Ask your Advisor the right questions, and you could find out if he really knows his stuff, or if he is really putting you into overly-risky bonds to try to impress you with returns. The name of the game is "preservation" in this environment, so you can be ready, when the financial crisis is over, to pick up the bargains of a lifetime. If you are unsure about the safety of your current municipal bond portfolio, please give Stamper Capital & Investments, Inc. a call at (949) 673-5787, and our expert Portfolio Manager, B. Clark Stamper, will do a complimentary portfolio review and consultation.

Stamper Capital & Investments has been positioning our clients over the past several years in preparation of what we are forecasting. If we are right, the past three years will seem like a walk in the park compared to what is coming. We intend our clients to not only just 'survive' what is to come, but to be in a position to make once-in-a-lifetime investments at fire-sale prices. If you are interested in discussing our forecast further or would like to inquire about privately managed municipal bond accounts, please contact Stamper Capital & Investments at (949) 673-5787 or email us at **separatelymanagedaccounts@risk-adjusted.com**.

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