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2012: Seeking Yield

More investors are piling into muni bonds, but certain cities face intractable economic difficulties.

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"If 2011 could be described as the Year of Fear" after numerous muni bond defaults, says TIAA-CREF's Barnet Sherman, "then 2012 is the Year of the Yield." Seeking yield, that is. Optimistic or not, the notion of government bonds providing a no-brainer income guarantee—that investors can set it and forget it—are gone. "You have to do your homework."

He's got a lot more homework now. Although muni bonds have been around since 1945, when a trifling $20 billion of municipal debt was outstanding, today's market is nearly $4 trillion, and its dangers are multifaceted. Even the tax exempt status of munis may be at risk. The only certainty is uncertainty.

Data from Concord, Mass.-based Municipal Market Advisers, a research and advisory firm, show a rolling 12-month total of 100 municipal defaults for the period ending July 26, 2012, a drop of 50% from the previous period, and the greatest decline since 2009. That's an improvement (if small comfort for investors in those particular munis). But there are still warning signals as certain cities face economic difficulty. Within three weeks in June, three California cities authorized filing for bankruptcy. Also this summer, debt obligations forced Scranton, Pa., to cut payroll—slashing fire and police compensation to $7.25 an hour. The city of San Bernardino, Calif., borrowed against its future property taxes—but then was hit with property foreclosures. False filings showed the city had been in the black for 16 years, when it was actually in the red for 13, according to the city attorney.

The deception typifies the types of risks I found two years ago after reviewing the procedures used by Moody's Investors Service. An October 2009 paper by Moody's described its rating process and a series of weightings it used. The yawning gaps between the assumptions that supported weightings and real-world municipal practice left plenty of room for sloppiness and fraud to slip through the agency's analysis. Moody's, for example, favored states with oversight boards, which it believed "ensured consistent standards of financial integrity." But of the two local finance boards the agency cited, in North Carolina and New Jersey, the former's finance board was peppered with political appointees and New Jersey's commissioner was forced from office in 2009 by an FBI raid. Also, Moody's continued to favor munis with higher numbers of new construction permits, according to the October 2009 paper, even though it was widely known by then that overbuilding had helped collapse the economy in 2008.

Not surprisingly, municipal fund managers take ratings under advisement, but rely on their own research. At the same time, the muni market is facing difficult economic realities and beefed up regulatory oversight. Expected prohibitions in the Volcker Rule, for instance, influenced a decision by Citigroup Global Markets to shelve its plans to trade municipal bonds in tranches (much the same way it did mortgages).

"The muni tranches market wasn't there for the product," says Mikhail Foux, a Citi researcher and analyst. But the bank did succeed in getting the form used in municipal credit default swaps (MCDS) standardized to match corporate insurance contracts. That uniformity allows contracts to unwind easier, making the insurance more attractive, which could prove positive for higher-risk bonds from states like California.

Also promising is that for the first time since 1996, local governments are paying back more debt than they're taking on. In