Munis: Better Than Treasuries?

By Stephane Fitch, April 22, 2009

Tax-free bonds offer some nifty bargains.

There's a lot of fear at the moment that cities and states will default on their debts. The panic has left the municipal bond market in shambles. It's full of opportunities, too.

That's because, in some corners of the market, yields spreads have been turned on their heads. In a rare twist, some tax-free munis are offering the same or better yields as taxable Treasuries of the same maturity and, in some cases, with little or no greater risk.

If you're holding U.S. government bonds right now, you're painfully aware of the stingy yields. T-bills that mature in a year or less are paying 0.5% (annualized). The five- and 10-year Treasuries pay a mere 1.8% and 2.9%, respectively.

AAA-rated muni bond maturing in five years is yielding around 1.8% now, which is about the same as five-year Treasury bonds. But with the munis, that's a taxable equivalent yield of 2.6% for investors in the 30% tax bracket.

People who've spent a lifetime dipping in and out of the muni market are giddy. That's especially so for money men like Chicago investment advisor Mitchell A. Kovitz. He and his firm's bond trader, Richard Salerno, have been buying lots of muni bonds for their high-net-worth clients. Their firm, Kovitz Investment Group, manages $1.1 billion in assets, with $480 million of that invested in fixed-income securities.

"Before the market blew up late last year, I'd only seen munis yielding more than Treasuries on a couple of days in my career," says Kovitz, whose Chicago firm Kovitz Investment Group handles $1.1 billion in assets, including $480 million in bonds. "This has been going on for weeks and weeks now."

One of the best deals going for the skittish may be so-called pre-refunded munis. The name comes from the fact that when a municipal bond issuer decides to retire old debt early, it doesn't just mail out checks. It buys special Treasury bonds called "Slugs," which stands for "state and local government series." The issuers then direct the interest and principal on these bonds to the previous holders of the relevant muni bonds. Bottom line, pre-re muni bonds are backed by the U.S. Treasury—and are tax-free to boot.

Given this generous tax treatment, pre-re muni yields are usually significantly below those on equivalent Treasuries. Not today. Pre-re munis maturing in 2014 were recently yielding 1.7%, the same yield offered by the Treasury. So here's an opportunity to pick up something no more risky than a Treasury but, for anybody in the 30% tax bracket, with a considerably better income stream.

If your taxable investment accounts hold one- to eight-year Treasury debt, have your broker switch into pre-re munis with similar maturities. A caveat: Muni bonds aren't always quite as liquid as Treasuries.

Insured muni bonds are another interesting play.

Before the market blew up, state and local governments could reassure bondholders that if they ran into financial trouble, their bonds would be honored by specialty insurers, like MBIA (MBI), Ambac (ABK) and Federal Guarantee Insurance Company (FGIC). It was a cheap way for a municipal government with a rating of double-A or single-A to upgrade to AAA.

In April 2007, five-year insured muni bonds were yielding 4%, significantly less than the 4.7% offered on taxable five-year Treasuries. On a tax-equivalent basis, the munis were paying 5.7% for folks in the 30% tax bracket. Thus the insured munis were trading for almost the same exact yield as muni bonds from states and cities whose finances were rock-solid and carried a "real" AAA rating.

No longer. Ambac, FGIC and other big muni-bond insurers have weakened considerably. The 70-basis-point discount that insured muni bonds used to command vs. Treasuries has become a 50-bp premium. Five year Treasuries are yielding just under 1.9%, but insured AAA-rated munis are yielding 2.4%--or 3.4% on a tax-equivalent basis.

But what if the insurers go bust? Kovitz says it could happen, but that the sell-off is overdone. He's buying AAA-rated munis from governments whose finances have been rated single-A or double-A. Remarkably, the insured bonds usually offer a higher yield than ordinary single-A and AA-rated muni bonds without insurance.

Kovitz recently purchased AAA-rated Chicago Waste Water bonds maturing 2017 insured by MBIA. Chicago Waste Water's "natural" rating is A2 (Moody's) and A+ (S&P). Kovitz picked up the bonds with yields approaching 4.3% at a time when uninsured single-A munis were trading at yields as low as 3.7%.

Madness, says Kovitz. Even if the insurance is worthless, why pay less for bonds from a government whose finances are rated single-A just because the bonds are insured? Nor is the insurance worthless. Insurers may struggle to cover all state and local muni bond defaults, says Kovitz, "but you won't see them run out of money and fold up overnight." Even in the worst-case scenario, the accounts that the insurers set up to back the muni-bond issuers' payments will take years to empty out.

Kovitz is betting that, as the economy improves, it will become clear that the insurance accounts backing AAA-rated insured muni bonds are mostly solvent. The yields on these bonds will once again be at discounts to Treasuries.

Even if the windfall he and his clients are hoping for doesn't come to pass, there's something to be said for steering clear of the stampede into federal government debt these days, insists Kovitz. "I'm happy to sidestep a meltdown in Treasuries," he says.