



WARREN BUFFETT MAY KNOW MONEY, BUT HE DOESN'T KNOW MUNIS

Tax-exempt municipal bonds, or “munis” as we call them, have had a stellar record of safety against payment defaults, second only to US Treasury bonds. In the last few months, there have been a number of articles predicting widespread defaults of municipal bonds. Some of these so-called experts have gone as far as to claim that a collapse of the municipal bond market will repeat the pattern of the sub-prime mortgage implosion and the meltdown of banks and financial institutions that required an unprecedented bailout by taxpayers. Leading this charge in June, Warren Buffet testified before congress that he was expecting a “terrible problem” in municipal bonds, stating that the federal government will need to help. He went on to say that “I don’t know how I would rate them myself. It’s a bet on how the federal government will act over time.”

I simply don’t buy into this gloom and doom, and as a municipal bond investor, neither should you. Warren Buffett is a very smart man, but when it comes to munis, he’s out of his league.

I have been following state and local governments for 35 years through five recessions. Clearly, this recession is the deepest since the Great Depression of the 1930’s, and state and local governments are seeing unprecedented budgetary pressure, primarily because of revenue shortfalls in sales, income and property taxes. Revenue shortfalls themselves, however, are not unprecedented, and have marked every recession since 1973. Local governments have a number of tools at their disposal to get through recessionary periods. Those tools and resources are the number one reason why bond payment defaults have totaled less than ½ of 1 percent over the last three decades and why municipal bonds have often been called the second safest investment after U.S. Treasury bonds.

For all of the talk about rising municipal bond defaults, let’s put it in perspective. One expert says that 2010 is on pace to see \$3 billion of municipal defaults, and that is three times the average. In 2009, it has been cited that \$6.9 billion of municipals defaulted. These defaults were within a tax-exempt bond market of **\$2.4 trillion!** If 2010 were to see a quadrupling of last year’s defaults, it would amount to only 1.1% of all outstanding municipal bonds, a record of safety that would be the envy of any fixed-income debt market in the world.

Also keep this in mind: when municipal bonds defaulted at a rate of 15% during the Great Depression, this was a record never before seen and not seen since. However, 99% of those bonds that defaulted were eventually paid in full, making investors whole again.

Municipal bond critics cite unfunded pension liabilities as a leading cause for crisis; the fact is that this is not the first time that state and local pension fund liabilities have not been completely funded. In fact, the only time in history that municipal pensions approached full funding was in 1999. And pension liabilities are already seeing improvement in 2010, as many pension funds report a return to double-digit investment returns.

Finally, the US Treasury Advisory Committee, comprised of bankers and investment managers, reported in August that the municipal market

“appears to be in reasonably good condition . . . Broadly, municipalities still have a low probability of default, historically high recoveries . . . risk is mitigated by a number of factors, including state taxing authority, low debt/gross domestic product ratios, low debt servicing costs, high debt payment priority, expense reductions, alternate sources of funding . . . as well as rainy-day reserve funds.”



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Of course, there are areas within municipals that carry higher than average risk, such as industrial development bonds that may be tax-exempt but have no governmental backing and are paid by corporations that can go out of business. So, it pays to do your research, and an understanding of the historical research of the payment performance of municipal bonds is a good place to start. Perhaps Mr. Buffett should study this sector more before sending a shudder through a well-functioning market that builds our roads, bridges, schools, while generating safe, tax-free income to investors.

As for the need for a federal bail-out of the municipal bond market, I not only believe that it is not likely, but also unnecessary. State and local governments are for the most part required to operate with balanced budgets, a concept that is totally foreign to the federal government. The long track record of state and local government keeping annual operating expenses within that year's revenue is the main reason for the overwhelming safety of municipal bond repayment. Despite the ravages of this recession, that track record continues. Frankly, I have a lot more confidence in state finances than those of a federal government that has run annual deficits for 37 of the last 40 years.

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