



California is not Greece

Vanguard Research Commentary Jan 2011

Today, I bring you a summary of mutual fund giant Vanguard's optimistic forecast for the U.S. economy, and for municipal debt in particular.

[U.S. Economic Outlook](#)

For the first time in five years, Vanguard's Economic Dashboard favors better-than-expected U.S. job growth and a self-sustaining recovery.

[Municipal Bonds \(Muni\)](#)

Municipal bonds are issued by state and local governments to support social projects such as schools, highways, parks, drainage, etc.

Of late, much has been made of large budget deficits, pension shortfalls and shrinking tax collections facing municipal governments. Some analysts even predict widespread municipal bond defaults in 2011.

Vanguard does not anticipate a rash of Muni defaults because issuers have the ability and the willingness to make their debt payments. Additionally, tax collections have begun to improve and the broad U.S. economy is showing signs of sustained, albeit slow, recovery.

Strong Repayment History

On average, Munis are AA-rated and have rarely defaulted.

Over the past 40 years, high quality Munis had an average default rate of only 0.03% - about 1/30th of corporate bond defaults over the same period.

New York City in the 1970s, Philadelphia in the 1990s, and New Orleans after hurricane Katrina - all suffered significant financial difficulty, yet none of them declared bankruptcy *or* missed a bond payment.

Where Munis have defaulted, investors still recovered more than 99 cents for every dollar invested. So even in default, Muni investors did not lose a lot of capital.

Ability to Pay

Munis are either General Obligation (GO) Bonds or Revenue Bonds.

GO bonds are backed by the state and local governments' full taxing power. Revenue bonds are backed by fees and revenues, such as from highway tolls, water bills, etc.

Municipal bonds are structured to pay down debt over longer periods of time with smaller annual payments, which also helps avoid default.

For example, GO bonds have an average duration of 12.2 years, which is considerably more than the average 4.9-year duration for U.S. federal debt.

Willingness to Pay

For Munis to perform, governments must also be willing to pay.

State debt averages less than 2.8% of gross state product. So, not making debt payments has minimal short-term benefits but devastating long-term consequences that make future financings extremely difficult and more expensive.

Further, states cannot legally declare bankruptcy.

And local government bankruptcies are not permitted by many states (those that do, require prior state approval).

And with 70% of municipal bonds held by local tax-paying citizens, defaults would mostly harm local voters - not something politicians want.

There Are Concerns

In aggregate, 46 states faced budget deficits totaling \$130 billion in fiscal year 2011, and these financial pressures should not be ignored.

States need to raise revenue and reduce spending to close the gaps – both of which are hard to do with high unemployment and a weak economy. Therefore, states could see credit rating downgrades in the future.

However, Vanguard does not anticipate major bond defaults.

What Should You Do?

Investors interested in Munis should consider three crucial factors:

- Broad diversification. Consider holding a wide range of Muni issues, or a broad-based Muni mutual fund.
- Credit analysis. A Muni's yield alone does not determine its ultimate value; evaluate its yield relative to its default risk. Make sure your investment advisor does this and explains it to you.
- Low cost. Investment fees and costs can significantly eat into already low Muni yields. So make sure you minimize all costs and fees.

So that's how Vanguard sees it.

Consider this a comprehensive beginner's guide on the risks and benefits of municipal bonds – something I'd want all my listeners and readers to be aware of as you diversify your portfolio to minimize capital loss.