Insured municipal bonds and the individual investor

Why guaranteed bonds may be the right balance of income and risk for your portfolio

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"Investors will continue to get the benefit of their investment no matter what happens to the underlying security or to the financial stability of the issuer."

Richard Holzinger
Head of Investor Relations for Build America Mutual

Municipal bonds can play an important role in an investment portfolio by creating a steady stream of income while reducing overall risk and volatility. As debt instruments issued by state and local governments and backed by tax revenue streams, municipal bonds are a relatively safe investment option compared to other types of investment. The historical default rate for municipal bonds is .18% compared to 1.74% for investment-grade corporate bonds, according to the market's principal regulator, the Municipal Securities Rulemaking Board (MSRB).[1]

Municipal bonds are also often exempt from federal, state, and local taxes, providing investors with a tax-free income stream.

But like any investment, municipal bonds are not risk-free. Demographic changes or natural disasters such as hurricanes, earthquakes, or wildfires can disrupt the local economy over the lifetime of the transaction, which can result in a rating downgrade that causes price volatility. An issuer can fail to properly manage their debt potentially giving rise to a default, which happened in Stockton, California in 2012 and Detroit, Michigan in 2013. In addition, some transactions are poorly structured and carry financial risks for the investor even if the issuer remains solvent.

Municipal bond insurance is an unconditional and irrevocable guaranty that can protect investors against these risks for a modest cost.

The Benefit of Bond Insurance

Municipal bond investors receive a set number of interest payments and a return of the original investment once the bond reaches maturity. Municipal bond insurance guarantees timely payment of interest and principal, regardless of cause: Bond insurers have made payments in cases where issuers have experienced significant financial distress and declared bankruptcy, as well as cases where a missed or late payment was the result of an inadvertent failure or administrative error.
"The reason for the late or missing payment is immaterial," explains Richard Holzinger, Head of Investor Relations for Build America Mutual (BAM). "Investors will continue to get the benefit of their investment no matter what happens to the underlying security or to the financial stability of the issuer."

In addition to the fundamental promise of timely payments of interest and principal, bond insurance from Build America Mutual can provide additional benefits to investors:

1. Enhanced Transparency and Surveillance

The municipal bond market consists of more than 50,000 unique and distinct state and local government issuers. Many of these issuers are quite small and typically do not provide the robust reporting and disclosures of large, active issuers like the states of California or New York. As a result, municipal bond credit risk is inherently difficult to research, and it can be challenging for investors to stay informed about issues that could impact payments or indicate a chance of default over the entire life of a bond investment, which could stretch from 10 to 30 years or more.

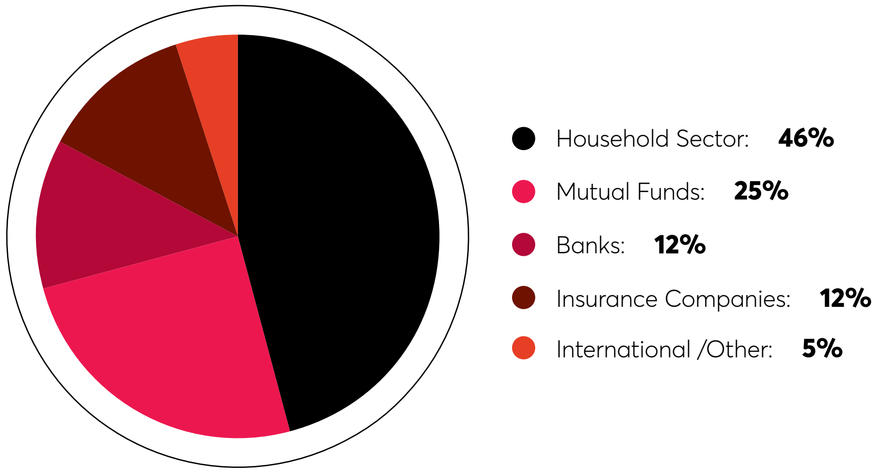
BAM provides investors with three-page BAM Credit Profiles on every issuer and bond it insures, free of charge. These profiles provide economic and demographic information, financial information, and key ratios and are updated annually.

[1] http://www.msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf

"Our issuers and our policyholders have one expectation for their bond insurer — to maximize capital and gain financial strength."

Individuals are the Largest Owners of Municipal Bonds

Holders of Municipal Securities, Q1 2019



Source: Federal Reserve Board

BAM also employs a group of seasoned professionals who monitor all issuers the company insures and conduct initial due diligence and continuing monitoring of economic, demographic, and political issues that could impact the issuer's ability to make payments. "We are extremely proactive in terms of identifying potential problems," explains Holzinger. "BAM will reach out, help analyze problems, and work closely with the issuer to get the municipality back on track. Our goal is to avoid default."

2. AA/Stable Rating

The rating agencies, including Moody's Investors Service, S&P Global Ratings, and Fitch Ratings continuously monitor the creditworthiness of both the underlying security and the issuer and assign a rating that identifies the likelihood that the issuer will default within a given time frame. However, that time frame is often shorter than the ultimate maturity of a newly issued bond, raising the potential for ratings volatility in response to fluctuations in an issuer's financial position due to changes in the local economy, fraud and other management issues, natural disasters, or other unforeseen developments.

A rating downgrade can result in lost market liquidity and lower pricing. While a downgrade by itself won't have a financial impact for investors who continue to hold the bond through maturity, a downgrade can cause anxiety even if the investor has no plans to sell the bond. If the investor does need to liquidate a downgraded municipal bond due to a life event — such as the need to fund a child's education or pay for a health crisis— the sale could result in a significant capital loss.

"Ratings volatility is a significant risk for investors who need to liquidate their bonds," explains Holzinger. "But even investors who plan to keep the bond until maturity benefit from insurance: They have the security that if unforeseen circumstances forced them to liquidate the investment, they would still have the benefit of BAM's AA rating."

How Bond Insurance Protects Investors **BAM municipal bond insurance guarantees payment of interest and principal on municipal bonds, when due. The promise to pay is unconditional and irrevocable and protects against a wide range of risks that can cause a default — some foreseeable and others that are not**	
Risk Type	**Potential Impact on Investors**
Natural Disasters	Hurricanes, earthquakes, tornadoes, and other natural disasters can cause short-term disruptions to local government cash flows, and loger-term damage to the tax base that supports many municipal bond issues. At the height of the crisis, communications breakdowns may interfere with the physical payment of debt service, while over time, bond issuers that rely on sales-tax or property-tax revenues may find they have inadequate resources to repay investors.
Pension Issues	Public pension funds rely on a combination of adequate contributions from employers and investment earnings to make the payments due to retirees. If either side of the equation falls short, governments can face fiscal stress, and payments to bondholders may be jeopardized.
Recession / Economic Stress	Layoffs, plant closings, and other dislocations associated with recessions and other economic stress can impact almost any source of public-sector revenue, from personal and corporate income taxes to sales and property taxes, and can even interfere with payment rates on bills for essential services like water and water treatment.
Administrative Errors, Fraud, or Other Payment Interruptions	Missed payments have also occurred due to administrative errors, political disputes, cyber-attacks that block access to computer systems, fraud and theft, or unforeseen expenses that exceed budgets.

3. Enhanced Liquidity

Unlike corporate debt that trades frequently, individual municipal bonds tend to trade much less often. Fewer trades translates into less transparency into pricing, and difficult price discovery can result in lower pricing.

Because there are more than $57 billion of BAM-insured bonds in the market, and more than $500 million of BAM-insured bonds trade per week, traders can extrapolate the price of infrequently traded bonds by analyzing the prices of other BAM-insured municipal bonds. Faster and less expensive price discovery results in better pricing for the investor. Says Holzinger, "small or mid-sized issuers can't provide the same level of transparency as large or frequent issuers. BAM's guarantee means that investors receive the same level of transparency and price discovery of a large issuer regardless of issuer size."

Why Build America Mutual?

Build America Mutual is the only municipal bond insurer in the U.S. that is organized as a mutual insurance company. BAM's stakeholders are exclusively municipal bond investors and issuers who are focused primarily on maintaining and building its capital strength, rather than generating dividends or funding stock buybacks. "BAM's mission is to build capital and financial strength without the distraction of a third party that is looking for a return on investment," notes Holzinger. "Our issuers and our policyholders have one expectation for their bond insurer— to maximize capital and gain financial strength."

Investors can purchase BAM insurance on municipal bonds in the primary or the secondary market. In the primary market, the issuer pays for the insurance; in the secondary market, a broker-dealer or investor, rather than the issuer, pays the premium.

Conclusion

For individual investors, municipal bonds can lower portfolio risk and serve as a tax-advantaged investment vehicle that optimizes after-tax returns. But with tens of thousands of issuers in the marketplace, each with its own unique characteristics and underlying economic complexity, it's nearly impossible for investors to keep abreast of all the risks that exist in the municipal bond market, especially given the long time frame for many municipal bond investments, which can stretch for 30 years or more.

BAM insurance provides investors with peace of mind that their investments are guaranteed. "The municipal bond market is very diverse, and BAM thoroughly underwrites and then monitors every issuer over the life of the insured bond," explains Holzinger. "This level of expertise and surveillance is essentially impossible to duplicate as an individual investor."

About Build America Mutual

Build America Mutual (BAM) is a mutual bond insurance company operated for the benefit of its members — the cities, states, and other municipal entities that use BAM's financial guaranty to lower their cost of borrowing — and the investors who hold their bonds. BAM only insures U.S. municipal bonds for issuers that provide essential public services, and has no exposure to transactions for U.S. territories like Puerto Rico, structured finance or international borrowers. BAM is the National League of Cities' preferred provider of bond insurance for its members and through March 31, 2018, BAM has insured approximately $54 billion of municipal securities for more than 3,000 municipal issuers nationwide. For investors, BAM guarantees timely payment of interest and principal, but does not guarantee market value of its insured bonds.

Learn more at http://buildamerica.com/mission/

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