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ARE HIGH-YIELD MUNI BONDS RIGHT FOR YOU?

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There are $3.7 trillion of outstanding municipal bonds, with hundreds of millions more issued each year. Munis have been termed "the second safest investment after U.S. Treasury debt". Despite Detroit's bankruptcy in 2013 and Puerto Rico's defaults this year, defaults over all muni bonds through their final maturity are less than 1%, and even less when you consider bondholders' recoveries after a default.

High yield munis pay higher interest than traditional city or state backed debt, because default rates in this sector are considerably higher, as high as 10% over the life of industrial revenue bonds (which may be tax-free, but are no stronger than the private company that repays the debt). Other high-yield sectors include hospitals, private colleges, senior living projects, distressed governments, tobacco bonds and charter schools. These bonds can yield as high as 10% plus annually. But there is no free ride—these bonds are risky, usually rated very low or carrying no bond rating at all.

Most munis are backed by governments that are "legal monopolies" with the power to raise taxes or fees on essential services like water or sewer service. The common feature of high-yield munis is that they are vulnerable to competition. A good example might be a hospital that loses patient share because of a better-run or new hospital opening in its service area.

It would be unwise to have your entire investment portfolio in these projects unless you have a very high appetite for risk; diversity should still be an objective. But investors with diversified portfolios and are not ultra-conservative might find these bonds to be a form of hedge where returns may perform differently than the rest of your portfolio.

About the Author

RICHARD P. LARKIN, Stoever Glass & Co., Inc.

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.

Disclosures: