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MUNICIPAL BONDS: CREDIT RISK VERSUS MARKET RISK

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Credit risk and Market risk are two different concepts. Market risk can be triggered by Credit Risk. Credit risk is the possibility that the issuer of your bonds won't generate sufficient revenue to make timely repayment of your investment. Detroit's bankruptcy and Puerto Rico's failure to make payments on debt are examples where credit risk has lowered the market value of bonds. Trying to predict municipal bond defaults is what I have done for a living for over 41 years.

Despite bankruptcy and defaults by Detroit and Puerto Rico, about 99% of outstanding municipal bonds are not in default, nor are they likely to abruptly stop repayment of that debt. That observation is backed by studies that go back to the Great Depression of the 1930's.

However, even the strongest issuer's debt is subject to Market risk. When the Federal Reserve raises general interest rates, most bond prices will fall, regardless of how strong the issuer might be, even "AAA" rated issuers.

The best strategy to deal with market risk is to diversify your holdings with "laddered" investments, meaning holding municipal bonds with various maturities. As interest rates rise (which many have predicted for several years) your current principal repayment can be re-invested at the new higher rate. The key is to stay invested. Trying to predict interest rates is a crapshoot regardless of your expertise in the market. Interest rate levels are the result of a "herd" mentality, which is more psychological than predictable. Your best strategy is to remain invested at wherever interest rates might be at any point in time. Unless you are Nostradamus, predicting interest rates over 10-20 years is futile.

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.

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