An Inside Look at the Rating Game

Often, comparing the ratings of municipal bonds can be somewhat misleading. For example a hospital's A rated bond is obviously weaker than the A rated general obligation bond of the town in which it is located. In dollars and cents the impact is that some investors, looking at ratings only, and not differentiating among the various types of bonds, may get less value for their money. The knowledgeable investor who considers the type of municipal bond more than the rating, may benefit by increasing yield without sacrificing quality. This article will show you how to evaluate the various types of municipals.

The type of bond will usually tell you more about the bond's quality than the rating will. Almost without exception, we prefer general obligation bonds and established water, sewer and electric revenue bonds in preference to other types of municipals. That's because general obligations have a claim on property taxes, and utility revenue bonds are backed by the income derived from the sale of essential services. That's the kind of security we like for our clients. So much so that only after we separate the many types of municipals into various categories do we begin to consider the ratings. To show you what we mean, let's divide the various types of bonds into "quality brackets" for you, the way our bond traders and bond analysts do when they buy bonds.

(1) In the first bracket are the general obligation bonds and essential service revenue bonds such as water, sewer and electric revenues. Usually general obligation bonds, backed by the credit of the issuer and taxing power on real estate, are generally considered the best type of tax-free securities you can buy. And as a group, it is our opinion that general obligation and essential service bonds generally have more inherent security than the rest.

(2) In the second bracket belong most state sponsored Housing Finance Agency bonds, road, bridge, and tunnel revenue bonds and airport revenue bonds (only those payable from the gross revenue receipts of the entire airport).

(3) The third bracket includes many of the industrial revenue bonds, hospital, nursing home, and extended care bonds.

Naturally there are exceptions in every bracket, but when put into group classifications, those in Bracket #1 are generally considered to be of higher quality than those in Bracket #2, which are generally better than those in Bracket #3. So look at the rating only after you have taken the type of bond into account, and be more willing to accept a lower rating if the bond falls into the first bracket; become more demanding as you look at bonds in Bracket #2 and take only the better ratings (A, Aa and Aaa) in Bracket #3. Using this method will help you get the most yield without sacrificing quality.

There is an oddity in the ratings system that we can't understand. Why do they use the same symbols for corporate debt as they do for municipal debt?

While the symbols used (Baa for example) are the same, there is no way that the actual quality is the same for corporate debt and G.O. municipal debt. The real quality is consistent with our bracketing system. Look at our Bracket #3, where we have included "many of the industrial revenue bonds." An industrial revenue bond is simply a tax-free municipal that is backed by a single corporation, exactly the way corporate debt is backed by a single corporation.
Why should a Baa general obligation municipal have the same quality symbol as a Baa corporation? Corporations can and do go out of business. Towns don't move or go out of business. Taxes have to be paid to the municipalities, corporations can be replaced.

One further point to remember is that there is a much bigger difference in quality between an A rated general obligation bond and an A rated hospital revenue bond than there is between one general obligation bond rated "A" and another rated "Baa". And that is reflected in the yields and prices the various bonds bring in the market.

A word of caution, particularly important when dealing with revenue bonds of all types; be sure to determine whether the bond represents an existing, fully operational facility, an addition to an existing facility, or a completely new facility. Obviously, the actual quality is best for a bond with a proven record of revenue payments. It is also usually quite easy to predict what the payment record will be for a bond issued to extend a successfully operating revenue producer, so these are second best. But when rating bonds issued to create totally new projects, the rating services must rely upon engineering estimates and predictions. And since the future is obviously more difficult to predict when there is no past upon which to base judgment, insist upon a higher rating when considering this type of bond to allow for a margin of error.

When looking at ratings, it is also very important to realize that an issuer earns an investment grade rating if it is comfortably meeting its obligations and if no future difficulties are foreseen. Whether it earns a "Baa" rating or a "Aaa" rating depends on how wide and how stable its margins of protection are - in other words, how far into the future its investment quality can be assured. The shorter the maturity of the bond the less important the rating, and vice versa. Because when an issue is rated, the rating service takes the longest maturity into account, and with it, all the possible trends and contingencies that might occur between now and then. The shorter maturities of the same issue are safer because they are far less susceptible to unforeseen changes. So, when buying short-term bonds, you can consider buying a Baa-rated bond thereby taking advantage of the higher yields while at the same time getting a bond that, if evaluated separately, would deserve a much better rating.

What Do The Ratings Mean?

Many very good bonds have no rating at all and others are under-rated. And, over the years, we have been able to pick up many undervalued bonds for our clients by looking beyond the ratings. A common misconception is that non-rated bonds are so low in quality that they don't even merit a rating. But low quality is probably the least likely reason for a general obligation bond to be non-rated. A good rule of thumb when talking about general obligations or established essential utility revenue bonds is to assume that when a small or infrequent issuer is non-rated it is a reflection of low debt, and therefore, a plus. Scarsdale, New York, one of the wealthier communities in the

Moody's and Standard & Poor's are the two major municipal rating services. Not all bonds are rated by both. Of the two agencies, Moody's rates more issues and tends to be more widely followed by professionals. On the occasions when the two agencies disagree on the quality of a bond ("split rating") Moody's tends to be the more conservative.

MOODY'S	S & P	S & P DEFINITIONS*
Aaa	AAA	.. Best Prime Grade
Aa1	AA+	.. Best of the High Grade
Aa	AA	.. High Grade
A1	A+	.. Best of the Upper Medium Grade
A	A	.. Upper Medium or Good Grade
Baa1	BBB+	.. Best of the Medium Grade
Baa	BBB	.. Medium Grade

nation, was non-rated for many years because it never issued any debt to speak of. When it finally began to borrow it was rated Aa, and there are other similar non-rated bonds of Aa quality in the market today.

Ba1	BB+	.. Some Speculative Elements
Ba	BB	.. Speculative Elements

Moody's appends numerical modifiers 1,2, and 3 to each generic rating classification from Aa to Ba.

For S & P, the ratings may be modified by the addition of a plus or minus sign to indicate relative standing within the major categories. (Plus (+) or Minus (-)).

**Excerpted from "Moody's Bond Record" and Standard & Poor's "Municipal Bond Selector."*

A bond may be non-rated because Moody's or Standard & Poor's may have withdrawn the rating. Usually that happens when small issuers which have not issued new securities for a period of time neglect to send updated financial statements to the rating services. Since these municipalities do not intend to come to market, there is no financial advantage to be gained by keeping the rating services updated. So unfortunately, some of them become too lax in this regard and ratings are withdrawn. As soon as an issuer decides to issue bonds again, financial statements are resubmitted to the services and the ratings are reinstated. The time to beware is when a large and frequent issuer has its rating withdrawn. Because, although it happens infrequently, both Moody's and Standard & Poor's will pull a rating when they feel that quality has deteriorated or that pertinent information is being deliberately withheld. Among the bonds we do not recommend for our clients are Certificates of Participation (COPs) because they are subject to annual appropriations and in a credit crunch, non-appropriation of funds might occur causing a suspension of bond payments. We also avoid Redevelopment Agency Revenue bonds and other lease backed issues where the leases may be non-renewable.

Usually it is only when considering nursing home revenue bonds, hospital revenue bonds, small industrial revenue bonds and other such revenue bonds that "non-rated" is cause for concern. Issues of this type, which yield much more when the Bond Buyers Index for 20 year A-rated bonds, should be a dead giveaway. These investments are speculative. Some of these types of bonds have defaulted and even the so-called "good ones" have limited marketability, so we recommend bonds of this type to clients who have risk tolerance and the investment objectives to make these securities suitable.

Another type of municipal we are wary of and do not recommend for our clients are the tobacco settlement bonds. These bonds are supported by settlement agreements entered into between the tobacco companies and various states, and depend on large sums to be paid by the tobacco companies over the next twenty or thirty years. But with one multi-million dollar suit after the other, will the tobacco companies be able to pay all the billions they owe to the states? And with more and more people quitting and fewer starting, plus all the suits, will the tobacco companies be around twenty years from now?

We also feel that municipal bond insurance for general obligations or essential service revenues is overrated and could almost be considered more of a gimmick to gain approval for bond fund companies rather than an added credit value. That's because the security behind most general obligation bonds or essential service municipals is actually stronger than the insurance companies. During the Great Depression of the 1930's, many insurance companies went bankrupt and more have gone bankrupt since. However we agree that the extra layer of security is comforting.

Remember to keep the ratings in proper perspective. Ratings are approximate classifications, not infallible guarantees. It is a mistake to compare municipals only by ratings. First make sure they are the same type of municipal bonds, then look at the rating.

Although the above information and statistics are not guaranteed, they have been obtained from reliable sources and are believed to be accurate.