FIXED INCOME

Fundamental Changes That No Muni Investor Should Ignore

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The investment landscape for municipal bonds has changed in a number of ways. What was true in the past for this asset class may not be anymore, according to Sheila Amoroso and Rafael Costas, co-directors of Franklin Templeton Fixed Income Group's Municipal Bond Department. They emphasize the importance of exercising discretion when choosing to invest in certain areas of the muni market, but still believe there are good reasons for investors to consider the asset class.

What to Believe and What to Question

We believe it's time to take a good hard look at the municipal bond market, because what was true 10 years ago, very well may not be true today.

First, here's what we believe is still true about munis—they are still a great source of tax-free income for a wide variety of investors. Additionally, municipal bonds as an asset class are second only to US government-related issuers in terms of credit quality among US-issued securities. That's the good news.

So, what may not be true about the market anymore? First and foremost—the treatment of creditor claims by distressed issuers has changed dramatically. Investors may not be able to trust that previously inviolable security pledges like general taxing power and specific tax revenue pledges will still be honored by issuers in times of distress. While we believe that municipal issuers' *ability* to pay is generally still second to none, in our opinion, the *willingness* of distressed issuers to pay has been seriously undermined in the last five years.

The combination of recent municipal bankruptcies, the treatment of creditor claims and the increasing pressure on state and local governments brought on by inexorably increasing public pension and benefit obligations demands a significant shift in how municipal general fund debt must be analyzed. Unfortunately, we think this is now the reality of the municipal-bond landscape, and it may only get worse as more and more cities and states are running out of options to make good on all the promises they have made to their creditors, public employees and taxpayers.

Advisors and investors should be aware of this change in the municipal capital markets and know how their municipal bond management team is approaching investing in munis today. We believe the best way to handle these situations is to avoid them from the beginning, giving wide berth to issuers that appear to have unsustainable budget situations.

Bankruptcy Rather than Compromise

The bankruptcy cases in Stockton (California), Detroit and now Puerto Rico (including most of its issuers) have each led to increasingly punitive actions toward bondholders. Not all that long ago, when municipal issuers experienced financial difficulties, they would often approach the bondholder community and work out solutions satisfactory to all sides. The relatively low number of municipal bankruptcy filings since the 1930s is partly a testament to that approach. Issuers seemed to understand the stigma that bankruptcy and default would carry and the negative consequences for their future market access. Workouts were often achieved through negotiations among stakeholders at a much lower cost in legal fees and time than is experienced in today's bankruptcy proceedings.

By contrast, today when push comes to shove, some municipal issuers and their legal advisors may be increasingly likely to choose to harm bondholders' interests rather than make budget or political choices that could be unpopular with their constituents—residents, public employees, pension recipients or business owners. For issuers, the decision to impair bondholder rights may make sense—at least in the short term. Bondholders generally don't live in these jurisdictions in great numbers. They don't vote, pay taxes, consume services or contribute to political campaigns in these jurisdictions. Bondholders can be vilified as "Wall Street," a convenient and faceless boogeyman.

What seems to be forgotten is that bondholders may have funded a new fire station, helped to build the town library, and financed a community's water treatment plant or its electric generation and distribution system. Also lost in the rhetoric is that, ultimately, most investors with holdings in

municipal bonds are not "Wall Street," but just regular people, often in retirement themselves, trying to generate income through ownership of mutual funds or individual bonds.

The Longer-Term Impact on Distressed Issuers

There are long-term costs to issuers who turn their backs on bondholders. The most obvious of these is the significant impairment of access to the capital markets. Municipal issuers need to realize that the "market" for their debt is rather limited compared to most other securities, many of which have broad global markets. Taking overly punitive actions against the very creditors that issuers will need to meet future infrastructure needs is counterproductive and will likely have a very negative impact on their ability to borrow going forward.

The California cities of Vallejo, Stockton and San Bernardino have not been able to access the capital markets on a stand-alone basis since their respective bankruptcies. Puerto Rico has had virtually no access to capital since the spring of 2014, a fact which has become painfully visible as it struggles to recover from Hurricanes Irma and Maria. Aside from charity, the only source of significant financial assistance remaining to Puerto Rico is the US government. The municipal bond market, its most consistent source of funds for decades, is now also closed to Puerto Rico.

Franklin Templeton and Puerto Rico

For more than three decades, Franklin Templeton was proud to invest in Puerto Rico. The bonds we purchased helped fund the development of the island's infrastructure and maintain it in good working order. However, as the financial picture there deteriorated, we began to reduce our exposure. Unfortunately, by the time Puerto Rico made known its intentions to default on its debts we had not completely exited our positions, and therefore we have remained involved as stakeholders in negotiations, mediation and court proceedings.

Puerto Rico has defaulted on its General Obligation (GO) pledge, its electric utility debt and other debt. We highlight these defaults because if an issuer in distress like Puerto Rico is allowed to abrogate such crucial security structures (GO pledge, dedicated revenues and special revenues) without allowing bondholders to seek their legal remedies, then no rate covenant or other security feature obtained when we purchase a muni bond will be adequate to protect us when we need it the most.

We take responsibility for our decisions to invest in Puerto Rico bonds. But we made those investment decisions because we believed in the strength and sanctity of the security features and protections—now violated—that we were granted in the indentures.

What is important going forward is that we make investment decisions in the context of the changed default-risk environment.

Where Do We Go from Here?

As a result of lessons recently learned, the Franklin municipal bond group generally does not purchase general fund appropriation debt from cities, counties or states that in our view are facing unsustainable structural budget situations. Such issuers are merely kicking the financial can down the road, and we now have real and recent experience showing us how that road is likely to end for bondholders.

So as real examples, the Franklin municipal bond group has divested from—and currently won't invest in—obligations of the State of Illinois, the City of Chicago and Chicago Public Schools, no matter what they offer in terms of security. We are skeptical that such issuers would behave any differently toward bondholders than Stockton, Detroit or Puerto Rico have. In fact, we believe that their legal advisors, emboldened by the results of these recent bankruptcies, would recommend even more punitive treatment toward bondholders.

We think investors should exercise similar discretion when choosing among municipal bond managers, paying special attention to a manager's exposure to the more troubled names in the muni universe.

We have learned some very real and painful lessons in the last few years. What's more, we believe that there are more difficult situations ahead and that investors should know how asset managers are assessing those risks and how they are managing their exposure to them. We are willing to sacrifice some short-term gains in favor of exercising experience-based prudence for long-term results. We believe investors should expect nothing less.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in the funds adjust to a rise in interest rates, the funds' share prices may decline. Funds that invest in a single state are subject to greater risk of adverse economic and regulatory changes in that state than a geographically diversified fund.

Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. The funds may invest a significant part of their assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project would likely affect all similar projects, thereby increasing market risk. Some funds hold a portion of assets in Puerto Rico municipal bonds that have been impacted by recent adverse economic and market changes, which may cause the fund's share price to decline.

For investors subject to the alternative minimum tax, a small portion of fund dividends may be taxable. Distributions of capital gains are generally taxable.

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