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Don’t confuse ‘junk’ bonds with non-rated municipal bonds

NON-RATED MUNICIPAL BONDS

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The term “non-rated” is one that most investors typically avoid, fearing that it translates into “unsound” and “unreliable.” However, those who stop there are missing out on a valuable investment opportunity — non-rated municipal bonds.

Municipal bonds typically seem appealing because they are perceived to be stable and reliable and they offer a tax-free investment vehicle. Investors associate them with safety rather than stratospheric returns. As a result, below-investment-grade municipal bonds are viewed as being highly undesirable investments.

Some investors assume that non-rated bonds are similar to “junk” bonds, with the same attendant risks. This is not the case. Junk bonds have been examined by a rating agency and determined to be below investment-grade. They carry a higher risk of default than investment-grade bonds, albeit with the potential for high reward.

Non-rated bonds, on the other hand, have simply not been rated by any agency, because their issuer has declined to seek a rating.

TYPICAL ISSUERS

Typical issuers of non-rated bonds include:

- **Small issuers.** Issuers seeking to support projects such as a new school gymnasium, an auditorium or other small undertakings who do not plan to issue more bonds again any time soon, if ever, may opt to forego a rating in order to lower the costs of issuance on the bonds if they believe obtaining a rating will not significantly lower their borrowing costs by reducing the interest rate they can obtain. As a result, they do not feel the need to build up a ratings history, especially when doing so would require them to pay an agency.

- **Tax increment refinance zones.** TIRZs are government-created districts intended to draw new investment to an area that would otherwise likely have trouble attracting significant development. The taxing entities involved sign a tax increment pledge to keep funding the TIRZ — and any municipal bonds it might issue to raise capital — throughout its lifespan of 30 years or less. Theoretically, the taxing entities could default on the pledge. Rating agencies tend to give TIRZ municipal bonds below-investment- grade ratings precisely because of this concern. However, in reality, such defaults are incredibly rare. As a result, TIRZ municipal bonds may not be rated, but they are a good investment.

- **Municipal utility districts.** MUDs are entities created by the Texas Commission on Environmental Quality to provide services such as water, sewage and drainage as part of the community development process. They are important tools in getting new communities off the ground.

MUDs, managed by publicly elected boards of directors, are formed when more than 50 percent of property owners in a proposed district petition TCEQ. Although MUDs can fund themselves through fees and taxes, they often issue bonds instead. Since these districts are new, they have no history of consistent tax or bond payment. A MUD that receives a below-investment-grade rating on its municipal bonds will not qualify for municipal bond insurance until an investment grade rating is achieved. As a result, many avoid rating agencies until later in the development process.

Back in the 1980s, many districts in Texas sold bonds to fund aggressive development plans. Developers that couldn’t keep up with increasing taxes following the end of the interest-only period of four or five years would default and walk away.

Now, however, districts are prohibited from issuing bonds too quickly, with the state requiring them to have established at least 25 percent of the projected value of their entire development project on the ground and enough taxable property to pay the projected debt service on the new bond issue before the bonds are sold.

Taxes are levied on all taxable property in the MUD and the proceeds of such tax are used to pay the debt service of all bonds issued. In addition, MUDs generally do not sell municipal bonds until their assessed valuation is between \$20 million and \$25 million.

Below-investment-grade municipal bonds are viewed as being highly undesirable investments.

JUDGING BONDS

A would-be non-rated municipal bond investor should check with the Municipal Advisory Council of Texas, a clearing house of information on bond issuers, and search the Internet and other reference sources to get a broader history on the issuers involved.

If no major red flags are found in the bond issuer’s background, it’s time to confer with a financial adviser who may have a bond portfolio that offers non-rated municipal bonds, analyzing issues and issuers prior to making any investment.

As always, common sense should rule. Any investment that seems to be too good probably is.

Non-rated municipal bonds, like many other types of investments, are not right for everyone. However, they can work well for many more people than would typically seek them out.

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