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## *Update on Municipal Bonds*

With interest rates at historic lows and expected to remain so for some time, many investors have embraced municipal bonds for yield. So far this year, about $51 billion in new money has poured into municipal-bond mutual and exchange-traded funds. Given that municipal-bond funds total some $510 billion in assets and have been around since the mid-1970s, fully 1/10th of their total assets is new since the beginning of the year.

With demand outweighing supply and the Fed's easy money policy, municipal bond yields have fallen to their lowest level in 50 years while prices have risen. As one observer noted, municipal bonds have become both pricey and risky. In addition, their tax-exempt status is on the table in Washington's ongoing "fiscal cliff" negotiations.

Morningstar, a financial research firm, recently published a review of state pension plans, looking at the fundamental characteristics that separate healthy, fiscally-sound states from troubled, fiscally-stressed states. The report is entitled "The State of State Pension Plans: A Deep Dive into Shortfalls and Surpluses" and in it, Morningstar analyzed two specific characteristics.

The first, the funded ratio, is a state's pension fund assets divided by its liabilities. It is a good measure of the plan's ability to meet its obligations. The second characteristic is the unfunded liability per capita, which is the amount that the state's taxpayers theoretically would need to pay in order to fully fund the plan liability. Morningstar points out that at the end of the day, taxpayers are ultimately responsible for their state's pension liabilities.

The healthiest state in Morningstar's analysis is Wisconsin. It has a funded ratio of 99.8%, meaning it is practically fully funded, and an unfunded liability of only $23 per taxpayer. At the other end of the spectrum is Illinois with a funded ratio of only 43.4% and an unfunded liability of over $6,500 per taxpayer. Our own state of New Hampshire is the fifth worst with a funded ratio of 57.5% and an unfunded liability of more than $3,250 per person.

Morningstar notes that while the majority of state pension plans continue to experience declines in their funded ratios and increases in the unfunded liabilities per taxpayer, the volatility of these factors has decreased since its peak in 2009. Also, the fiscal health of pension plans tends to change slowly and struggling plans usually can be identified years before a crisis hits.

In these difficult times, investors in municipal bonds need to tread carefully. Quality always matters, even more than yield or tax treatment.

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