The ongoing upheaval in the financial sector has left many of us veteran institutional investment managers yearning for the good old days, circa 2005. Then, collateral values were on a one-way trip northward, margins were, if not great, at least tolerable, delinquencies were at record lows, and your investment portfolio caused you little concern. You may have had a nominal net loss from a market value standpoint (and in fact the typical community bank investment portfolio was about at break even), but a general maxim was that your bank's tax-free bank-qualified municipal bonds were something you needn't worry about. This mind-set, I can safely say, has gone the way of balanced budgets.

Update on Muni Insurers
The table on page 60 shows a "current" table of the municipal insurance industry. You recall that virtually the entire handful of acronyms that were the muni insurers was downgraded or merged between 2007 and early 2009. The surviving entities are either investment grade (at the moment) or are writing literally no new policies and seem destined for extinction.

By the time this shakeout was in full bloom in late 2008, intermediaries like ICBA Securities began paying careful attention to the "underlying" rating. The underlying is the rating that is irrespective of any insurance policy. Many, many issues have no underlying, because it simply wasn't cost-effective to pay the agencies a fee when the insurer was rated AAA/Aaa, or the issue was simply too small.

Going forward, you should be very aware of an issue's underlying rating. That will be the most relevant indicator in determining the market value and liquidity of an offering. You may have noticed that, in the last 60 days of 2008, your muni market values fell substantially.

Get Well Quick
The January effect was felt this year in all its fury. This is the phenomenon that occurs every year in bank-qualified ("BQ") land. The limited supply of new issues in the early part of each year, coupled with high demand, work to push prices higher. In 2009, we can say much higher.

The low supply is the result of there being, from...
1986 thru 2008, a cap of $10 million per year for an issue to be bank qualified. Many millions of dollars get issued very late in the year to beat the clock. The high demand is residue of Jan. 1 being the most popular date on the calendar for both maturities and calls.

Predictably, prices rose in January. For example, AAA bank-qualified yields generally fell over 50 basis points in the 15- to 20-year maturities. This resulted in handsome price appreciation, as you may have noted in reviewing your bond accounting data.

Wait, There’s More
The American Recovery and Reinvestment Act (ARRA), signed into law on Feb. 19, 2009, stopped the muni rally in its tracks. The act provided for an increase in bank-qualified volume to $30 million annually, and a number of issuers acted immediately to grow supply.

Another section of ARRA allows banks to purchase up to 2 percent of assets in non-BQ paper and pay only a 20 percent TEFRA penalty (versus 100 percent). This in effect will further lessen demand for BQ paper, at least temporarily. Both provisions currently have a 2010 sunset date.

So, the January effect was quickly unwound. Increased supply, decreased demand and voilà! Muni market sell-off. At least we can conclude the tax-free market is acting rationally. Bank-qualified yields rose about 50 basis points in the two weeks following the enactment of ARRA, during which time general market muni yields rose only 10 bps. Time will tell whether supply will shrink, demand will grow or the sunset codicil is enforced.

And, for you Alternative Minimum Tax (AMT) fans, issues dated 2009 and 2010 are not subject to AMT, whether BQ or not, as long as they are outstanding. You can therefore expect ’09 and ’10 issues to carry slightly higher market values in the future.

In the meantime, be very careful about any non-BQ issues you contemplate purchasing. Bank-qualified issues are rarely private-activity bonds like nursing home revenues or parking garages. They tend to be used for essential purposes like schools and sewer systems, and therefore have general obligation backing, which is usually preferable.

To repeat, a word to the wise would also be to pay close attention to the underlying ratings. We have been recommending that a bank review its investment policy, vis-à-vis tax-frees and perhaps mandate a minimum underlying rating. That is a logical step in maintaining credit quality, and certainly liquidity, in this very important investment sector.