Despite Detroit, muni market remains solid

July 19, 2013

Key highlights

- Vanguard funds have very small exposure to Detroit debt, and all the debt held is insured.
- Detroit's bankruptcy does not suggest a broader problem. The city's insolvency will remain a very small exception rather than the rule in the municipal bond market.
- We continue to suggest exposure to municipal bonds as part of a diversified portfolio.

Detroit's bankruptcy filing should not worry Vanguard investors. Like many in the bond market, we had anticipated this insolvency. Our clients' exposure to Detroit debt is minimal, and Vanguard continues to believe that municipal bonds can make sense as part of a diversified portfolio.

The insolvency represents the latest chapter in the long-term decline of a city that once symbolized American economic might, but bond investors had expected it, given Detroit's decades of economic problems.

"The news of the Detroit bankruptcy doesn't actually come as a surprise to many municipal market investors because Detroit's structural challenges (high unemployment, shrinking population, severe financial mismanagement) are well documented," said Sarah Hammer, a senior investment analyst with Vanguard Investment Strategy Group.

Despite the city's Chapter 9 filing, Vanguard believes the municipal market is highly rated, with a limited history of defaults. *Governing* magazine reported that, overall, it's extremely rare for municipalities to declare bankruptcy, with only 13 cities or towns (about 0.06%) doing so since 2008. ("How Rare Are Municipal Bankruptcies?" by Mike Maciag, January 24, 2013.)

In addition, Vanguard investors face little exposure to Detroit debt:

Detroit debt held among all of our national tax-exempt funds

City of Detroit General Obligation	0.04%	$36.7 million
Detroit Sewer System	0.05%	$50.5 million
Detroit Water System	0.07%	$69.4 million
Total Exposure	**0.16%**	**$156.7 million**

(Figures as of 7/18/2013)

All Detroit debt in Vanguard funds is insured by Assured Guaranty or National Public Finance Guarantee. Both companies have sufficient claims-paying resources should that become necessary. Detroit continues to make principal and interest payments on the water and sewer debt, and the city's emergency manager has deemed those obligations secured by the revenues from those services.

In addition, Detroit debt represents a tiny fraction—just 0.05%—of the entire muni bond market. Most state and local governments are in significantly stronger fiscal shape than Detroit, so while investors may see more filings from individual municipalities, Vanguard does not expect a significant increase in these types of bankruptcies.

"State and local governments have the ability and willingness to continue to make their debt-service payments," Hammer said. "Tax collections have begun to improve, and the broad U.S. economy is showing signs of sustained, albeit slow, recovery."

Vanguard believes that municipal bonds remain appealing, especially given recent federal tax increases.

Background

On July 18 Detroit filed Chapter 9 bankruptcy, seeking to restructure $18 billion in debt. The filing followed Detroit's June announcement that it would stop payments on about $2.5 billion in unsecured debt. The city also asked creditors to accept about 10 cents on every dollar in a move to avoid bankruptcy.

Experts in municipal markets have expressed worries that Detroit's filing raises questions about the safety of general-obligation bonds. Investors have long believed that these bonds would have senior status over other obligations. But Detroit officials have argued that the city should not have to prioritize payments to investors in general-obligation bonds over other creditors, including city workers.

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Ultimately, those decisions are up to a judge, and bond investors will be watching this case carefully.

Notes:

- All investing is subject to risk, including the possible loss of the money you invest.
- Bond funds are subject to interest rate, credit, and inflation risk.
- Although the income from a municipal bond fund is exempt from federal tax, you may owe taxes on any capital gains realized through the fund's trading or through your own redemption of shares. For some investors, a portion of the fund's income may be subject to state and local taxes, as well as to the federal Alternative Minimum Tax.

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