



Build America Bonds Power the US States

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A skeptical attitude toward new products has long served the best interests of advisors and their clients, almost without fail. Advisors, however, should not be afraid to embrace one of the market's most prominent recent innovations: the Build America Bond (BAB).

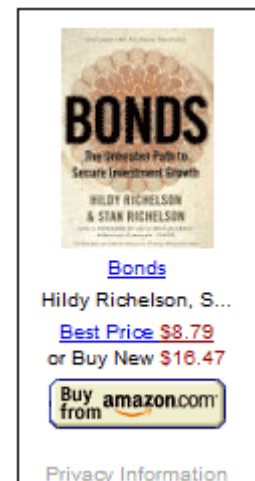
While BABs are different from traditional tax-exempt municipal bonds, they are still issued by the same state and local governments. Because they are new, they yield more than either agency or corporate bonds. They are backed by a federal tax credit that gives them added support, and their many large issues provide market liquidity.

Before I explain the compelling features of BABs, let's review the program under which they were issued to see exactly how they differ from corporate and traditional municipal bonds.

Background

The BAB program, created by the American Recovery and Reinvestment Act (ARRA) of February 2009, permitted a federal subsidy of municipal borrowing to help alleviate the states' great economic distress. Instead of issuing tax-exempt bonds, municipalities can now issue taxable municipal bonds and receive a federal cash subsidy equal to 35 percent of their interest costs for new projects only. Municipalities could issue as many bonds as they wanted in 2009 and 2010. Issuers have switched to now receive most of their funding from BABs, with maturities of 15 years and longer being the most common (because low rates in that portion of the yield curve offered the cheapest financing). In the first 16 months of the BAB program, states issued over \$105 billion in BABs, or approximately 25 percent of the municipal new issue market.ⁱ

BABs opened up new markets for municipal debt. There was enough demand and liquidity to attract institutional buyers for multi-million-dollar deals. Most taxable bonds are long-dated, so BABs give insurance companies and pension funds the ability to match their long-term liabilities with their assets. Mutual funds and ETFs have also been big purchasers of BABs. Individual investors purchase the bonds through these vehicles and





can also buy the bonds directly. The BABs are ideal for retirement funds, and they are a new taxable alternative for individuals in low marginal tax brackets.

BABs, which carry the partial backing of the U.S. Treasury, are taxable debt that should appeal to global buyers. Though foreign governments were wary of BABs initially, the near-implosion of Greek debt has since made these bonds much more attractive.ⁱⁱ

Short sellers who bet on the default of Greece and other sovereign nations' bonds are now betting on the default of some states using credit default swaps (CDS). For a series of payments, the buyer gets face value of a bond in the event of a bond default. The CDSs have only deepened awareness of the need for change and adaptation, and they have not harmed BAB issuers by increasing bond yields.ⁱⁱⁱ

BABs are less risky than sovereign debt. According to Moody's, the default rate on sovereign bonds since 1970 has been 6.36 percent, while the default rate on municipal general obligation bonds was 0.01 percent for the same period.^{iv} The recovery rate on defaulted municipal US debt is far superior to the recovery rate on sovereign bonds. For dollar-based investors, high-quality BABs are the obvious choice.

Pricing of BABs

BABs are priced in relation to Treasury bonds. The risk premium on BABs varies with the credit of the issuing municipality.

When the BAB program began, yield spreads to equivalent-maturity Treasury bonds were very attractive. Since it was a new product and did not have wide acceptance, the buyers were primarily institutional investors. The New Jersey Turnpike was one of the first issuers, and its initial spread to comparable Treasuries was 370 basis points in April 2009.^v

Evaluating the meaning of the spread between BABs and Treasury bonds is difficult. If the spread widens, that does not necessarily mean that BAB credit has deteriorated. It may mean that there has been a flight to safety that increased purchases of Treasury bonds and lowered their yield. Such was the case in May 2010, when the Greek debt frenzy exploded; BABs did well, but Treasury bonds performed better.^{vi}

Another factor affecting BAB pricing is the supply available. Prices fell in May and June 2010, for example, because approximately \$10 billion of BABs were newly issued during that period.^{vii}

BAB bond yields may not move in tandem with traditional tax-exempt municipal bond yields, because they sell in different markets with different supply and demand. The supply of tax-exempt bonds diminished as issuers chose to sell BABs instead. Another reason is that high-net worth individuals pour money into tax-exempt municipal bonds even when



their prices rise because they seek both protection from anticipated higher taxes and stability in the face of stock market volatility.

Municipal Ratings

At the inception of the program, the most respected issuers sold BABs, and the recent recalibration of municipal credits on a global scale has given BABs additional support. A global scale ranks all bonds based on their likelihood of default, regardless of the nature of the issuer. For example, US Treasury bonds, certain municipal bonds and a select few corporate bonds are rated triple-A. The US Treasury bonds are a better credit than either of the other two. Municipalities lobbied that their credit should be evaluated on the likelihood of default, just as corporate bonds are. The ratings agencies switched to global ratings in 2009 and 2010 and placed corporate and municipal credits on the same footing, resulting in rating upgrades for municipal credits even during the latest credit crisis.

The rating scales of the rating agencies have not changed, though. The ratings have just become more generous in certain circumstances. Of the states, California (Moody's Baa1 to A1) and Puerto Rico (Moody's rating from Baa3 to A3) were big beneficiaries of the global scale changes. Issuers whose ratings went from the triple-B to single-A benefited in the way their bonds performed in the market because it widened the number of possible buyers.^{viii} Standard and Poor's, Moody's and Fitch all made the changes, though in different ways and according to their own schedules. Overall, the market has easily adjusted to the re-ratings.

Structure of BABs versus Corporate Bonds

When comparing BABs to corporate bonds, there are a few considerations: The call structure of BABs may be different; the tranche size of the corporate bonds is significantly larger; and the default rate among corporate as opposed to traditional municipal bonds is higher.

The call structure of BABs sometimes resembles traditional municipal structures and other times those of corporate bonds. Like corporate bonds, many BABs have no fixed call, or only a make-whole call. Municipal issuers generally have a fixed call, and sometimes extraordinary calls and sinking funds.

A fixed call enables the issuer to redeem the bonds on a specified future date and at a specified price, and generally anytime thereafter. The bond call is triggered if interest rates are sufficiently low to enable the issuer to profitably refinance.

A make-whole call is not interest-rate sensitive. If the issuer decides to exercise its right, it must pay a specified amount based on a complex formula designed to benefit the investor who purchased the bonds at the new issue price.^{ix}



An extraordinary call enables the issuer to call the bonds in case of special events, such as damage to the project being financed or an IRS audit.

A sinking fund redeems a set number of bonds on specific dates. The bonds redeemed may be chosen by lottery or purchased in the open market.

Make-whole calls and extraordinary calls are completely unpredictable. One cannot take these calls into consideration while determining if the yield-to-call is sufficient remuneration for the risk of owning the bonds. If you purchase the bonds at a premium price higher than the call price, you risk losing the difference if the bonds are called prematurely.

Corporate bonds are generally issued as one tranche of bonds from \$500 million to a \$1 billion. These bonds are called “term bonds” because the majority of the bonds of a given issue must be redeemed on the same maturity date.

BAB bonds have issuing tranches between \$4 and \$5 million. If there are serial bonds, where a specified amount of bonds must be redeemed every year, then the size of the tranche might be even smaller. Because of this, the spread between the bid price and the ask price is much wider than it would be on its corporate bond counterparts.

In terms of credit quality, investment-grade municipal bonds have a lower default rate (0.0651%) than corporate bonds (2.0885%) over the period 1970 to 2006, according to a Moody's study of municipal and corporate defaults over 36 years.^x

Bondholder protections

Like sovereign nations, states have the ability to raise taxes and reduce expenditures in order to meet their debt obligations. BABs, like traditional municipal bonds, have many kinds of credit support. They may be traditional general obligation bonds that are issued in taxable form, or they may be revenue bonds supported by income from a variety of revenue sources. As with any bond, the credit strength of a revenue bond is dependent upon the types of guarantees and the depth of resources supporting the bonds, and the strength of the general obligation bond is based on the breadth of taxing power of the issuer.

Some political pressures have received substantial media attention. Most notably, the underfunding of some state pension plans has drawn scrutiny. Though it is difficult for them to do so, unions have been giving back benefits in order to retain jobs, and benefits for new employees have been curtailed in some states. In other states, like Illinois, major changes will probably not occur until after November elections. So far these changes have been enough to satisfy bond holders.

It is vital for the states to retain access to the credit markets to create the infrastructure of our economy. Restructuring any municipal debt issue is messy. The news reports pit the



funding of pension funds against the repayment of bondholders. This approach obfuscates the issue of how state officials and administrators could approve of and issue bonds said to be highly rated when their pension funds were in such dire straits.

Bond ETFs are Linked to Bond Market Indices that Include BABs

As BABs have become a larger presence, the indices that track taxable bonds have begun to include them. BABs, for example, now make up 9.3% of Barclays Capital U.S. Long Credit Index. To be included in an index, bonds need to liquid so that reliable pricing can be obtained.

When bonds are included in an index, funds that track the index must purchase them, creating an active market. SPDR Barclays Capital Long Term Credit Bond ETF and Vanguard US Investment Grade Credit Index Fund track Barclays Capital U.S. Long Credit Index.

Invesco PowerShares has launched a BAB fund that tracks the BofaMerrill Lynch 1-12 Year Build America Bond Index. SR Nuveen Barclays Capital America Bond is a passively managed ETF. State Street Global Advisors in conjunction with Nuveen have six municipal bond ETFs.

Despite their inclusion in bond indices, investors are likely better off owning individual BAB securities than purchasing a fund or ETF. Despite price fluctuations, individual bonds will repay the face value of the bond when due. The individual bond buyer has greater clarity about the bond purchases as opposed to relying on packaged products such as funds and ETFs.

Indices established as benchmarks for bond EFTs may be proprietary. Unlike the venerable stock indices, these indices may be modified monthly. Every change in the index will trigger buying and selling in funds that track the index, which increases the operating costs of the ETF or fund. If the fund is designated as passive, it will not sell a troubled security that is still in the index, exposing index holders to potential losses. Since the fund may only have a sampling of the securities in the index, it will have larger concentrations of some securities, which will affect the fund's net asset value, for better or for worse. Depending upon the number of issues actually held by the fund, it may be classified by the fund itself as non-diversified, exposing index holders to additional risk. Therefore, before cheering how your ETF is performing in relation to its index, make sure to compare the nature of the index to that of the ETF.

The BAB subsidy program is set to expire at the end of 2010. Many members of Congress favor its continuance at lower subsidy rates. The survival of these indices and BAB-based ETFs depend on the continued issuance of new bonds. If the program for BABs is not renewed, some of these funds might be merged with traditional corporate bond funds.



Yields will probably rise as the BABs are sold off, creating a buying opportunity for individual investors.

Investment Advisors Use BABs

Financial advisors have started using BABs in their client's retirement accounts in lieu of other taxable bonds.^{xi} They are a good substitute for corporate bonds, federal agency and Treasury bonds. BABs do not compete with Certificates of Deposit for use in retirement accounts, because CDs are generally short-term, and BABs are usually issued in the longer end of the market. Most corporate debt also has shorter maturities than the BABs, while the overall credit quality for BABs is better than for corporate bonds. BABs provide portfolio diversity for the corporate bond buyer. Moreover, they have a higher yield than comparable corporate bonds, and they are supported with a federal subsidy.

Build America Bonds are an ideal choice for investment advisors looking for high-quality taxable bonds for retirement accounts and for investors in lower marginal tax brackets. Their high yield and low risk profile should endear them to investors and advisors alike.

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