The Key Issues in Today’s Muni Bond Market
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Thinking about supplemental sources of cash flow, retiring, changing jobs or selling your business? A predictable cash flow from a portfolio of high-quality individual tax-exempt municipal bonds can meet your needs. When you purchase individual muni bonds on a regular basis, you are creating a system with the reasonable expectation that it will get you to a better place in your life. Scott Adams, in his new book How to Fail at Everything and Still Win Big, explains that a system is usually at the foundation of achieving success, as opposed to setting a goal in the hopes that at some time in the future you might achieve it: “A system is something you do on a regular basis that increases your odds of happiness in the long run. If you do it every day, it’s a system. If you’re waiting to achieve it someday in the future, it’s a goal.”

Investing in high quality municipal bonds paying a predictable cash flow and returning your principal at the end of the investment is a well-trodden system for lifetime economic success. In this article we discuss some key issues in purchasing municipal bonds to help you make wise choices for your investing system.

Key Features of a Municipal Bond

Bonds are knowable because they share a basic structure. The key features of a bond are ratings, coupon, issuer, maturity date, yield, and call date. Some bonds are insured. Here are some bond basics that will help you understand the basic structure of a bond.

Packaged Bonds. Individual muni bonds may be packaged into bond mutual funds, exchange-traded funds (ETFs), closed-end funds and unit investment trusts. When individual bonds are packaged, they lose a key feature of individual bonds – a due date. That is why we recommend purchasing individual muni bonds. With high quality individual bonds you can plan on getting your money back when the bonds come due. You do not know what will be returned to you in a packaged investment, and you will be charged ongoing fees. You will not know what is inside the package unless you take the time to look and can evaluate the package. If you did look you might not be happy with the package and may decide to buy your own individual bonds.

Ratings. Ratings are supplied by Moody’s, Standard & Poor’s (S&P), Fitch Ratings and occasionally by Kroll Bond Ratings, the new kid on the block. The ratings are a shorthand way of summing up the financial strength of a town, county or state. When you consider a bond, always ask about the specific sources of revenue that are backing the bonds. If you are offered a new bond issue, ask to see the Preliminary Offering Statement (POS) and read the section entitled ‘security.’ That will tell you how the issuer plans to repay the bondholders. If the description makes your eyes glaze over, then pass on the opportunity.
Coupon. Troy, Michigan, recently issued general obligation bonds rated triple-A by Standard and Poor’s, its highest rating. These bonds have a 4.125% coupon. That means that for the duration of the life of these bonds, interest payments will be fixed at 4.125%.

Due Date. The Troy bonds come due on November 1, 2028. Maturity or due date is the specific date when the issuer promises to repay the face amount of the bond.

Call Date. Most bonds are originally issued with a call in 10 years, though some, like the Troy, Michigan bond has only call protection for eight years. A fixed call is a specified date when the issuer can but is not required to redeem the bonds. After the first call date the bond continues to be callable according to a schedule that is generally a call on the anniversary date. General obligation bonds tend to have fixed calls. Some bonds may also have other kinds of calls. Read our book BONDS: The Unbeaten Path to Secure Investment Growth for further explanation.

Yield. All bonds have a yield-to-maturity which is the return assuming that the bond will stay outstanding until its due date. All bonds that are callable have a yield-to-call, which is the return assuming that the bond is called on its first call date.

Research. You can verify information about an outstanding bond by going to EMMA, the website of the Municipal Securities Rulemaking Board (MSRB). This site brings needed transparency to the municipal bond market. It contains offering statements, material events describing actions affecting bonds as well as trade activity.

If you take the time to understand bonds, you can purchase your own high-quality individual bonds. A good rule of thumb is to see if Mr. Market prices similarly rated bonds the same. If the market pricing is significantly different, the bond you are considering may not be a bargain, but rather an indication of an unknown or unseen risk.

Bond Insurance. Some bonds are insured. This means that an insurance company guarantees to pay any interest due and principal at maturity. Insurance companies are not currently sporting the most desired triple-A rating that many had before 2008. Although municipal bond insurance has been battered since 2008, the existing companies are currently meeting their obligations in municipalities that have been having financial difficulties. While insurance cannot make a bad bond good, it is reassuring to have your interests aligned with those of a substantial company if you happen to own those bonds. Here is a quick summary of major insurance companies:

Build America Mutual (BAM), which is currently rated AA by Standard and Poor’s, is owned and operated by the municipalities that it insures. As such, it is in the self-interest of the issuers to insure only low risk issues. It is not a public company.

Assured Guaranty, which is currently rated AA- by S&P, has insured municipal bonds for many years. It is the only survivor of the insurance company meltdown in 2008, when the public bond insurance companies, supposedly dedicated to only insuring municipal bonds, decided that insuring mortgage-backed securities
was too lucrative to pass up. Assured Guaranty has created a new company called Municipal Assurance Corp. (MAC) rated AA+ by Kroll.

National Public Finance Guarantee Corp is the company formed to protect bonds formerly insured by MBIA, one of a number of public companies that insured mortgage backed securities.

**Key Issue of Rising Interest Rates**

The media and many broker-dealers have been predicting rising interest rates since December 2008. This was the date when the Federal Open Market Committee (FOMC) cut the bank lending rate to its lowest level in history - 0.0 to 0.25% - to increase money supply at a time of great economic uncertainty. Five years later, we are still waiting for the economy to be firmly in recovery and for interest rates to rise substantially.

Although there is much discussion as to the negative impact that rising interest rates will have on your bond portfolio, there has been no discussion of the cost of waiting to invest until after interest rates have risen. We have written about the impact of keeping your investments short-term in another Advisor Perspective article called *The Short-Term Route to Long-Term Failure*. If you wait to invest you lose interest income each day and your choice of when to invest must be rather precise to not lose out on your bet. In order to catch up from waiting, investors often feel they must take greater risks to compensate for the lost revenues. This may result in substantial risks.

Usually media reports globally describe interest rates as either rising or falling, believing that there is little interest in the detail. However, the interest rates on 2-year bonds will fluctuate in a pattern that is different from that on the 5, 10, 15, 20 and 30-year bonds. The different maturities generally do not move in lock step. If short-term rates rise, for example, longer-term rates may fall. It is very important for you to be clear what maturities are rising and which are falling in order to avoid global thinking. When different maturities are lumped together in global thinking, you miss the distinctions that make the difference.

Interest rates, or yields, correlate inversely to bond prices. As a consequence higher interest rates result in lower prices. Picture a see saw or a scale of weights and measures. When they are balanced, the bonds are selling at face value or par. The scales adjust with the movement of interest rates. The post of the see saw or the scale is the coupon, which remains the same. When interest rates in the market rise, prices fall and vice versa.

Market talk of falling bond prices resulted in heavy selling of bond mutual fund shares earlier this year. Some savvy bond fund owners realize that bond funds are best held when interest rates fluctuate moderately or are falling. When the fund owners fear rising interest rates, which will reduce the value of the fund, they often chose to sell. It is a well-known and documented fact that market-timing investors usually net less profit than if they had stayed the course.

On January 1, 2013, the 10-year Treasury bond had a 1.86% yield. On Oct. 22, 2013, the yield was 2.63%, an increase of 77 basis points (41%). There are 100 basis points in 1%. Between the same two dates, the 30-year Treasury bond increased 64 basis points, from 3.04% to 3.64%. The reason for this dramatic shift was
the belief that the Federal Reserve would take action to reduce or eliminate its program of buying bonds to suppress interest rates. This turned out to be a head faint, and no action was taken by the Fed.

As a result of the anticipation of even greater rate increases than had already occurred, many investors sold their bond funds. Oct. 17, 2013, marked the 21st week of significant outflows from municipal bond mutual funds in 2013.\(^{1}\) There have been $54 billion in outflows from muni bond funds this year, relative to a $4 trillion market. There were 29 weeks of outflows in the two-year period of 2010 to 2011 before the cash flow began to trend positive. Two causes of the outflow were the prediction by Meredith Whitney of massive muni bond defaults, and the downgrades of tobacco backed bonds.

The surge in bond sales from the funds caused an upward spike in interest rates and a decrease in bond prices as more supply came on the market. However, the prices didn’t fall as much as expected because the increased interest rates resulted in a reduction in the supply of bonds coming on the market. Municipalities that had hoped to refund higher yielding bonds were not able to secure sufficient savings and thus curtailed their issuance. In addition, the slower economy curtailed bond issuance for public infrastructure financings to 1997 levels. In 2013, we are on track for the second-slowest new issuance year in a decade.\(^ {ii}\)

**Key Issue of Credit Deterioration and Default**

If investors fear an issuer will default, its bond prices will fall as its yields rise. Muni default fears made it to the front page after Meredith Whitney’s infamously wrong prediction of massive defaults in the muni bond market on “60 Minutes” in 2010. This fear was recently brought back into the foreground again by the much-publicized defaults in California, and the (very predictable) default of Detroit bonds. New fears that Puerto Rico muni bonds might default riled the markets in October 2013, though yields came off their 8%+ highs as that likelihood receded. [Put a link to our article in Advisor Perspectives re Puerto Rico.]

It is important to keep in mind that “the average par default rate of municipals, traditionally considered a safe bet for long-term investors, for the period from 2008 to 2012 was 0.17% compared with a default rate from 1980 to 2012 of 0.13%, according to Kroll [Bond Ratings Agency].”\(^{iv}\) Municipal defaults are newsworthy because there have been so few of them. The largest share of defaults has traditionally been for bonds issued for special assessment, utility, transportation and industrial revenue bonds. These account for 72% of the total.

Of the overall default rate of 0.13%, the “general obligation bonds default rate increased from 4% to 23% of total defaults from 2008 to 2012, according to data from Income Securities Advisors in Kroll’s report.”\(^{v}\) Jefferson County, Alabama, general obligation warrants accounted for a substantial part of that increase because the warrants were not backed by any taxing power. Federal Judge Thomas Bennett placed the blame for the default on the Alabama Legislature’s elimination of an occupation tax that had been in place for a number of years and working as designed. He explained that by striking down the occupation tax in 1999 and failing to enact a sustainable replacement, the legislature precipitated the default.\(^ {vi}\) Defaults don’t happen immediately. As Judge Bennett put it: “Evaporation occurs over time.” The failure to replace the occupation tax with another source of unrestricted funding eventually resulted in a default.
Jefferson County reached a settlement with its creditors. However, the settlement was dependent upon the County's ability to sell new bonds. Because of rising interest rates, the County decided that the settlement it had agreed to was now unworkable. Moody's Dan Seymour said: “Jefferson County’s restructuring plan represents a novel approach in public finance: issuing new bonds to redeem defaulted ones at a loss to bondholders. This strategy for exiting bankruptcy relies on access to the market to fund bondholder recovery.”\textsuperscript{vii} Despite that the County was successful in modifying the plan and has proposed to issue new warrants for their sewer authority in December 2013.\textsuperscript{viii}

Most issuers wish to honor their bond debt. However, there are some governing bodies that fail to see the importance of paying those who have lent their institutions money, and they risk being closed out of the bond market. Or they may be able to float new debt, like Argentina, to those ‘yield hogs’ who believe it is different this time. Even if an issuer is in financial difficulty, the intent to honor their debt can result in price improvement. The yields on Puerto Rico’s bonds marginally declined and prices started to improve after its officials stated that bankruptcies were “out of the question” on an investor call in mid-October 2013.\textsuperscript{ix} Change does not happen all at once, but taking a stand is the beginning.

**Key Issue of Tax Benefits of Tax-Free Muni Bonds**

Federal income tax rates went up substantially beginning in 2013 for high-tax-bracket investors, particularly investors who are subject to the new 3.8% Medicare tax. Accordingly, individual tax-free municipal bonds are especially tax-effective for these high-tax-brackets investors, but muni bonds provide benefits to most people who pay taxes.

Tax-free muni bonds are the last straightforward tax shelter available to individual investors. Here is a simplified analysis of the tax benefits of tax-free muni bonds using the concept of a pre-tax equivalent return in two cases. In Case 1 the taxpayer is in the 28% marginal tax bracket, and in Case 2, the taxpayer is in the 39.6% marginal tax bracket. In both Cases we show the pre-tax equivalent returns for two possibilities: We first assume a 4% tax-free yield-to-maturity and then assume a 4.5% yield-to-maturity.

**Case 1.** The individual taxpayer is in the 28% marginal federal income tax bracket and considers buying two high quality tax-free muni bonds. One is yielding 4% and the other is yielding 4.5%. The yield-to-maturity and pre-tax equivalent returns are as follows:

- 4% yield-to-maturity. Pre-tax equivalent return is 5.55%.
- 4.5% yield-to-maturity. Pre-tax equivalent return is 6.25%.

**Case 2.** The individual taxpayer is in the 39.6% marginal federal income tax bracket and, in addition, is subject to the new 3.8% Medicare tax for a total marginal federal income tax bracket of 43.4%. The taxpayer considers buying two high quality tax-free muni bonds. One is yielding 4% and the other is yielding 4.5%. The yield-to-maturity and pre-tax equivalent returns are as follows:

- 4% yield-to-maturity. Pre-tax equivalent return is 7.27%.
- 4.5% yield-to-maturity. Pre-tax equivalent return is 8.18%.

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The pre-tax equivalent returns might even be higher if the federal phase-out of deductions are taken into account. In addition, if the taxpayer is subject to high state, county and city taxes, in-state bonds provide additional tax benefits. Thus, the pre-tax equivalent return to a taxpayer in the highest tax bracket may exceed 9% on high-quality tax-free municipal bonds.

**Market Discount Rate**

One very taxing aspect of municipal bond pricing is a very special tax provision that is not shared by other bonds. If interest rates rise substantially, this tax aspect may affect many bonds. Every bond that is issued has a market discount rate. If the market price you pay is below this discount rate at the time of purchase, then you will pay tax at your ordinary income tax rate on the gain — instead of at the capital gains rate — when the bonds are sold or come due. For example, if the market discount rate is 0.95 ($950.00 per bond) and the bond is priced at $960 or above, then the taxpayer will pay whatever the capital gains tax is on the gain. However, if the cost of the bond in this example is $940 or lower, the gain on the bonds will be taxed at the taxpayer’s ordinary income tax rate.

When bonds are offered to you, brokers will not ordinarily take into account this peculiarity of municipal bond pricing because everyone’s tax bracket is different. Unless you specifically ask what the after-tax yield is, you will not know what the true yield you will receive will be.

Because of this market discount rate tax rule, broker-dealers and funds often prefer to purchase premium bonds that are less likely to fall below the market discount rate. Therefore, if traders are worried about rising interest rates, they seek to sell their lower-coupon bonds. The yields may seem very generous, but you should take your personal tax consequences into account before you conclude your purchase.

**Risk Analysis**

Understanding pricing is especially useful when buying individual bonds. If you understand the base rate of the U.S. Treasury bonds, then you have a way of comparing the riskiness of one investment to another with fresh, current information. It answers the question: How is the market evaluating the risk in this investment today? It is especially useful to focus on the spread between the safest investment (U.S. Treasury bonds) and what you are planning to purchase if you tend to be a “yield hog” like most of us, wanting the highest yield without focusing on the risk.

To evaluate your risk, check the spread to U.S. Treasury bonds first. Then evaluate how the bonds’ yield compares to similarly rated issues you are considering. The yield difference is called the spread. If the market consensus (as shown by the yield) is that the long-term prospects for an issuer are negative, then the spreads will widen vis-à-vis similarly rated bonds. If the consensus is positive, then the spreads will narrow even if the ratings for the bonds are the same. Ratings are lagging indicators if they are not attached to newly issued bonds. Therefore, the ratings may or may not be indicative of market sentiment.

You might consider using the U.S. Treasury bond yield as the comparable baseline for whatever you purchase. Thus, if you are offered a juicy yield of 8% on an investment and the 30-year Treasury bond is
yielding 3.69%, a difference of 431 basis points (4.31 percentage points), you might ask yourself if you are prepared to take on the risk of loss that the higher yield represents.

**Key Issues in Tax-Exempt Municipal Bond Benchmarks**

Tax-exempt municipal bonds are compared to a composite of yields of similarly rated bonds. Municipal Market Data (MMD) and Municipal Market Advisors (MMA) provide benchmarks based on triple-A rated bonds. The two scales might not quite be in alignment because they use different evaluative criteria, including: securities selected, the weighting of those securities in the index and whether they are based on actual quotes or estimated yields.

Another company, Interactive Data Corporation (IDC), collects data and provides daily evaluations for municipal bonds. These evaluations “represent a good faith opinion of the price a buyer in the marketplace would pay for a security (typically in an institutional round lot position) in a current sale.” Many brokerage firms show the IDC pricing of bonds on a daily basis. However, if your bonds have not traded in a long time, or if you are purchasing an odd lot of less than 100 bonds, the price you are asked to pay may not match the IDC price. In June and July 2012, when interest rates were low, bond prices on customer statements appeared very high compared to the purchase price, showing large gains. However, if an investor decided to sell they might find the posted prices were unattainable because the actual market price might not match the index price on the statement. If you purchase a bond that is priced higher than the IDC price, then your online bond profile will show a loss the next day.

**Key Takeaways**

Investments in high-quality individual bonds provide a system enabling you to plan your retirement and financial independence because they provide predictable cash flow and a predictable return of capital.

Bond fund investments focus on gains and losses. Bond funds are a bet that interest rates will stay the same or decline.

Municipal defaults are newsworthy because they are historically rare.

Tax-exempt muni bonds are a tax-efficient investment for all investors, and the last great tax shelter for taxpayers in high tax brackets.

The website EMMA should become a good friend if you are buying individual municipal bonds.

Last, but quite important, if you are concerned with rising interest rates, buy your individual bonds arrayed in a bond ladder. Rising interest rates are the upside case if you have income or cash flow from redemptions that you can reinvest at higher interest rates than you are currently receiving.
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ii James Ramage. “Muni Funds See Outflows of 1.29B,” The Bond Buyer, October 17, 2013.
v Renick. Ibid.
vi Federal Judge Thomas Bennett. Memorandum Opinion on Application of Stays of 11 U.S.C. § 362(a) & 11 U.S.C. § 922(a) to Proposed Lawsuit Regarding Cooper Green Mercy Hospital, Case No.: 11-05736-TBB, Docket# 1524, Date Filed 12/19/12.