The Municipal Bond Market: Common Investing Mistakes

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C.W. HENDERSON
& ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

The C.W. Henderson portfolio management team has reviewed thousands of existing municipal portfolios over the last twenty-five plus years. Below are six of the most common investor mistakes we encounter and the reasons to avoid these potential investor pitfalls.

Lack of Ongoing Credit Research

Prior to 2008, there was limited need for serious credit research. Serious credit issues were infrequent and a large component of outstanding municipal bonds were insured by AAA rated bond insurers. Then things changed dramatically! Many bond insurers were severely downgraded while serious structural problems surfaced. Unfunded pension liabilities, Other Post Employment Benefit Costs (OPEB), variable rate exposure, cash flow problems and higher taxes (or lack thereof) now demand timely and thorough ongoing research reviews. In many cases, bond investors purchase bonds and never focus on credit risk. Avoiding credit downgrades and “spread widening” is all part of a “total return” approach to municipal bond portfolio management. Given today’s municipal market, we believe that not doing ongoing, consistent credit research is the biggest mistake municipal investors can make.

Purchasing Par Bonds/De Minimis Risk

Most investors prefer purchasing bonds at or near “par.” It is simple to explain and easy to understand. What most investors do not realize is that “par” type bonds have a little known and very costly risk known as “de minimis risk.” As a little known aspect of the Revenue Reconciliation Act of 1993, the IRS inserted the de minimis rule that negatively affected municipal prices when interest rates rise. The purchaser of a bond priced below the de minimis threshold must pay ordinary income tax on the bond’s appreciation back to par. This factor is not widely known because interest rates have, for the most part, declined significantly for the last thirty plus years. When rates do rise, the negative effects of de minimis may be shockingly dramatic. To avoid de minimis risk, investors should focus on big premium municipal bonds (bonds priced at $108 – $125).

Purchasing Bonds with Negative Convexity Characteristics

“Negatively convexed” bonds are bonds with longer maturities, “low” coupons and shorter call features. Price appreciation potential is limited when interest rates decline while price deterioration in rising rate environments can be much more substantial.

As an example, Hudson City, OH 3.00% bonds due 12-01-2035 with a 12-01-2018 par call are currently priced at 2.28% to the call with a dollar price of $101.544. The effective duration of this security is 2.13 years.

If yields increase by 1.50% over two years, assuming a parallel shift in the yield curve, both the bond’s price will decline and its duration will extend dramatically as the yield to worst shifts from the shorter call date to the 2035 maturity. Assuming a 4.25% yield to maturity in two years, the dollar price will drop well below par. Ignoring taxes, the price would fall to $84.836, a decline of 16.45%. However, because the bond has now breached its de minimis threshold,

and the appreciation back to par is subject to ordinary income taxes, its price would fall further - likely to about $80.585 – for a dramatic principal loss of over 20%. In this example, due to poor structure, the 1.50% rise in absolute yields will result in duration extension of more than ten years to approximately 12.80 years – further increasing volatility risk.

Conversely, in the extremely unlikely case of interest rate decline of 1.50% over two years, the bond will continue to be priced to the call and potential for capital gains generation is very limited. Bonds purchased with poor de minimis characteristics represent a terrible risk/reward for investors.

We are shocked at the number of inherited portfolios with “negatively convexed” structures.

“Reaching” for Yield

This is one of the most common mistakes we see today. Investors are purchasing longer maturities and/or buying significantly lower credit quality. “I just cannot live on lower returns” or “I need to earn more” are very common phrases that we hear far too often. Credit spreads are as narrow as they have ever been and interest rate risk is as high as it has ever been. Now is not the time to extend maturities and/or buy lower quality. If municipal rates were to rise, investors will likely be hit with a “double whammy” – both lower prices due to rising rates and credit spread widening that will create even more dramatic principal losses.

Buying “Odd Lots” to Enhance Returns

Smaller blocks of securities, or “odd lots,” are often utilized by investors as a way to enhance returns. While true that smaller blocks of bonds typically trade at slightly higher yields, these odd lots have limited liquidity characteristics. If an investor should need to raise funds or liquidate an entire odd lot portfolio, execution will be extremely poor. Bids from “street” firms are usually severely discounted – as they typically prefer to bid “round lot” blocks of bonds.

Compensation for financial advisors on retail-sized trades contributes to wide markups and discounts when trading desks buy and sell municipal bonds. A January 2012 study by the GAO (Government Accountability Office) found that the median spread for retail-sized municipal trades, blocks less than 20,000, was 2.20%. A markup or a discount of 2.20% on a portfolio constructed with small trades can equate to more than full year’s worth of returns in the current interest rate environment.

Ongoing credit research is extremely difficult on multiple odd lot portfolios. Buying odd lot securities also takes away opportunities to efficiently “tax loss” harvest when rates rise. Liquidating odd lots in dysfunctional markets can be almost impossible other than at “give away” prices.

Investing an Entire Municipal Portfolio in One Particular State

We commonly come across portfolios that are 100% invested in a client’s state of residence – when there is a tax benefit to owning in-state securities. We believe geographic diversification is prudent both to reduce concentration risk and to provide opportunities for significant return enhancement through the use of high coupon bonds with short calls and other strategies that utilize bonds from the national market.

Investing an entire municipal portfolio in one particular state is essentially putting “all of your eggs in one basket.” Credit deterioration of one issuer may have a profound destructive impact, albeit often temporary, on all issuers in the state. Orange County California’s 1994 bankruptcy, a result of its pooled investment portfolio purchasing risky, highly leveraged investments, led to sharply lower prices and varied illiquidity for most California issuers. Some mutual funds specializing in California debt dropped by almost 2.5% according to Lipper Analytical Services. Detroit’s 2013 bankruptcy, and the doubts regarding the State of Michigan’s willingness to assume outstanding general obligation debt, drove up the borrowing costs for other municipalities in the state. In the days and weeks after Hurricane Katrina devastated the Gulf Coast region in 2005, mutual funds that owned Louisiana debt universally underperformed the broader market. Nationally diversified portfolios reduce the likelihood that an investor will be adversely impacted due to concentration risk.

The deductibility of state taxes on federal returns provides investors with incentive to geographically diversify their portfolio. The below chart depicts the equivalent out-of-state municipal yield necessary to achieve a “break even” yield when compared to purchasing an in-state bond. It assumes residents in the highest federal tax bracket of 39.60%. Due to the demand for in-state bonds from residents in states with high tax rates (specialty states), yields on these bonds tend to be lower than on bonds issued by municipal entities in states with low or no taxes. We can purchase high quality bonds from “non-specialty” states such as Florida, Texas, Washington and Wisconsin and allocate them to specialty state client portfolios – typically picking up enough yield to more than offset the state tax and giving clients the added benefit of geographic diversification. To illustrate, a California resident who purchases a non-California ten year bond at 1.61% will have the same after federal and state tax effect as buying an in-state bond yielding 1.49%.

State*	Maximum Tax Rate	Highest Inverse Fed Tax Bracket	Effective Tax rate	Approx. 10yr AA Yield	Yield to Break Even	Approx. 5yr AA Yield	Yield to Break Even
CA	13.30	60.40	8.03	1.49	**1.61**	0.94	**1.02**
MN	9.85	60.40	5.95	1.49	**1.58**	0.94	**1.00**
NYC	12.696	60.40	7.67	1.54	**1.66**	0.99	**1.07**
OR	9.90	60.40	5.98	1.49	**1.58**	0.94	**1.00**
TX	0.00	60.40	0.00	**1.64**		**1.04**	

*Data as of 9/8/2016 (*Assumes “AAA” rated bonds in each state)*

Utilizing in-state municipal bonds on the longer end of portfolio structures in accounts of high state tax residents is appropriate. However, the advantage is diminished with rates near today’s all-time lows. In most cases, we can purchase “national” bonds, account for the state tax and end up ahead.

Summary

At C.W. Henderson & Associates, Inc. we add value to our clients' portfolios by avoiding these mistakes. We also add value (when tax efficient to do so) through active management, tax loss harvesting, etc. while investing in high quality, highly liquid securities that are regularly reviewed by our credit research group.

We hope these comments on common mistakes will help guide you to better investing in municipal bonds.

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