Municipal Bonds: Five Common Mistakes

Municipal bonds enjoy popularity because of their stable income distributions, tax advantages, and generally low risk. Although seemingly straight-forward, investing in municipal bonds is potentially complex. In this paper, we discuss five common mistakes unsuspecting municipal bond investors can make and offer our insights — some of which defy conventional thinking — on how to succeed in the municipal marketplace.

A Primer

Municipal bonds are debt obligations issued by states, counties, cities, or other government entities to finance public projects. The interest rate on municipal bonds is usually lower than on taxable bonds, but the interest earned is typically exempt from federal taxation and, in some cases, from state and local taxation. Municipal bonds may represent an attractive investment opportunity when the tax-free yield (the return an investor will receive by holding a bond to maturity) is higher than the after-tax yield on a comparable taxable bond.

The $3.7 trillion municipal bond market is large and actively traded, offering investors a wide range of issuers, credit qualities, and maturity choices.

Investor Missteps

The following are five common misconceptions among investors:

Mistake #1: "My broker's service is free."

On Wall Street, nothing is free. Several aspects of the municipal bond market lead to hidden costs. Unlike centralized stock market exchanges, the municipal bond market is a highly fragmented over-the-counter market with thousands of issuers, dealers, and investors negotiating transactions. To put it in perspective, if you were to gather all the municipal bonds in New York state and separate them according to their maturity dates, coupons, issuers, and credit qualities, there would be over 65,000 unique bonds to choose from — with 65,000 different corresponding prices. A stock sold on a centralized exchange, by comparison, is more or less the same for every investor.

The unstructured trading environment and the large quantity of distinct municipal securities — from states' to school districts' — can result in large price differences, even for similar-looking bonds. Adding to the murkiness is the practice among security dealers of including their commissions in the quoted price of the bond. Furthermore, many dealers keep an inventory of bonds that they trade for their own account, meaning they have a vested interest in the transactions. It is difficult to determine the true value of a bond and the embedded commission without comparing and analyzing many similar offerings. Even independent agencies whose sole task is valuing bonds can differ widely.

To illustrate the price inefficiencies in the market, we examined the trading activity of two municipal bonds over the course of given days in 2012 (Exhibit 1). For instance, the 5.25%-coupon Puerto Rican bonds (Puerto Rico is a U.S. territory), which

Exhibit 1: Price Inefficiencies

Issue	Date	Number of Trades	Coupon	Maturity	Price (Lowest/Highest)	Price Difference
Puerto Rico Commonwealth Aqueduct	June 6, 2012	160	5.25%	7-1-42	97.75/104.04	6.29
Triborough New York Bridge and Tunnel	June 7, 2012	11	5.00%	11-15-33	111.59/115.35	3.76

Source: Bloomberg

finance an aqueduct and mature in 2042, changed hands 160 times in an eight-hour span. Some buyers paid as little as $97.75 per bond, while others paid as much as $104.04 — a price difference of $6.29, or nearly $6,300 on a $100,000 face-value purchase. The next day, a bond funding New York bridges and tunnels traded just 11 times — but still at prices nearly 4% apart.

In another example, we put a New York City bond held by one of our clients "out for the bid" — that is, gauging buyers' interest without offering a price — and in 90 minutes received 14 bids, which ranged from $117.75 to $123.46, a nearly $6 gap (Exhibit 2). With such a wide dispersion of prices that people are willing to pay, it's very easy for unwary investors to be taken advantage of.

Tracking a bond's movements can be equally instructive. An independent valuation service recently priced a bond we were selling on behalf of a client at $117.02, which was close to our analysis of the bond's value. We then offered it at $118.26 in the hopes of finding a "motivated buyer." Shortly thereafter, a dealer accepted our offer and — after adding charges and adjustments — resold it the very same day for $120.84, to a retail investor who probably wasn't able to determine relative value and thought his or her broker's service was free. On a $100,000 purchase, the difference between the original valuation and final sale price was $3,819 — a sizeable sum.

Mistake #2: "I don't need a bond manager because I buy and hold."

The perceived low-risk characteristics of municipal bonds may lead investors to pursue a strict buy-and-hold strategy. In practice, however, this is not always feasible or in an investor's best interest.

To begin with, holding a bond to maturity can leave the investor susceptible to a loss of purchasing power. If you had purchased a $100, 20-year bond back in 1990, the $100 that you'd be paid back on maturity in 2010 would have been the equivalent of only $60 after factoring for inflation. In other words, inflation can seriously erode the value of a bond over time, and a strict buy-and-hold strategy could leave the investor unable to pursue investments better suited for inflationary environments, such as U.S. Treasury Inflation-Protected Securities (TIPS) or commodities.

Further, an individual's circumstances may evolve over time. Statutory tax rates often change meaningfully, which may raise or lower the attractiveness of municipal bonds to a particular investor. Or even if tax policy is unchanged, a person's own tax status may shift. For instance, in recent years increasing numbers of taxpayers have become subject to the Alternative Minimum Tax (AMT). In addition, an individual may need to sell part of his or her portfolio to meet personal liquidity needs such as unexpected health or legal expenses. When interest rates rise, a decline in a bond's value may provide an opportunity to harvest a tax loss. There may also be advantages to adjusting a portfolio's credit quality or maturity

Exhibit 2: Wide Dispersion of Bid Prices

Issue	Date	Number of Bids	Coupon	Maturity	Bid Price (Lowest/Highest)	Price Difference
New York Financial Authority	May 17, 2012	14	5.00%	11-1-20	117.75/123.46	5.71

Source: Bloomberg

such as substituting a deteriorating credit for an improving one, or repositioning the portfolio's duration to benefit from a future period of rising yields. In each of these cases, an investor forced to hold the bond until maturity would be at a real disadvantage.

Despite having an excellent history of creditworthiness, municipal bond issuers *can* encounter financial difficulties. Credit ratings agencies, such as Standard & Poor's and Moody's, analyze the potential risks and issue downgrades when they believe the financial health of an issuer is deteriorating. In 2011, Standard & Poor's downgraded 603 issues. Typically, a downgrade from AA to BBB would cause the bond price to decline by over 10% — potentially devastating for a bondholder who may suddenly need to sell the bond for any number of reasons.

While most municipal bond issuers meet their interest and principal payment obligations, certain bonds carry more risk than others. The risks are highest for 1) bonds that finance nontraditional or nonessential-service projects (such as a golf course); 2) healthcare facilities that don't live up to anticipated usage or suffer from changes in government reimbursement policies; and 3) bonds that finance projects that will be used by a business, in which case the issuing authority does not guarantee the bonds. Take, for instance, a short-term bond used to finance a multipurpose arena in central Washington state. When it was issued in 2008, the bond carried the highest possible rating for short-term notes, and the issuer had a respectable A rating. However, because the event center was a nonessential service (unlike a water or sewer system), its revenues plummeted when the broader economy faltered, leaving bondholders vulnerable. As a result, the issuer defaulted when the bond's principal was due in December 2011. Nine months later, bondholders still hadn't been paid back.

Mistake #3: "I have to buy municipal bonds issued in my state."

Investors occasionally pay more for a state tax exemption than the tax savings is worth. In some cases, investors can achieve greater after-tax return and portfolio diversification by purchasing out-of-state bonds.

Consider two similar high-quality investment alternatives for a Maryland resident, as shown in Exhibit 3. Both bonds are exempt from federal taxation, but only the Maryland bond is also exempt from state and local taxation. To determine the better choice, we need to evaluate the *after-tax* yield. In this case, it's worth purchasing the Texas bond, as its after-tax yield is 12 basis points higher, or 0.12%, despite not qualifying for the in-state exemption. In addition, diversifying with out-of-state bonds can help guard against regionalized economic risks.

Mistake #4: "I pay a lot of taxes, so I should only own municipal bonds."

Even though your tax toll may be sizeable, you might not be in the highest marginal tax bracket — in which case, municipal bonds may not be optimal. A growing number of U.S. taxpayers are subject to the Alternative Minimum Tax (AMT) rather than the standard calculation. Every year, taxpayers must calculate their income tax two separate ways and pay the higher amount.

Exhibit 3: In-State vs. Out-of-State Bonds for a Maryland Resident

Issue	Rating	Coupon	Maturity	Yield	After-Tax Yield
Calvert County, MD	Aa1/AAA	4.00%	4-18	1.00%	1.00%
Collin County, TX	Aaa/AAA	4.00%	2-18	1.18%	1.12%

After-tax yield reflects an effective state tax rate of 5% (assuming a federal tax rate of 35%).
Source: Bloomberg

- The traditional method allows all exemptions and deductions available under current tax law. Statutory rates start at 10% and graduate to 35%.
- The AMT method disallows certain exemptions and deductions that are allowed under the traditional method. While AMT rates are lower than the highest regular tax (statutory rates are usually 26% and 28%, and can be as low as 15%), the AMT calculation often results in a larger AMT taxable income base and, therefore, a potentially higher tax bill.

For investors who are subject to AMT, municipal bonds don't always offer the best after-tax solution. Sometimes, taxable bonds can provide higher yields because of the lower AMT rate. Moreover, certain municipal bonds are classified as "private activity bonds," which are not taxable for regular tax purposes but are subject to AMT.

Consider two municipal bonds issued to finance the Port of Seattle in Washington state (Exhibit 4). They have similar credit qualities, coupons, and maturity dates, but only one is subject to AMT. Comparing pretax yields suggests the AMT bond has a 54 basis-point advantage. But on an *after-tax* basis — which is what really matters — the AMT bond loses its appeal for investors who are subject to the AMT, because taxes erode the yield by almost 90 basis points. As many municipal bond funds hold sizeable portions of these bonds, some investors are surprised to learn that a significant slice of the interest income they receive from their "tax-exempt" bond fund is actually subject to taxation.

In short, because their bonds might not be exempt from federal taxes, investors need to be aware of the tax implications of the bonds they are purchasing.

Mistake #5: "If the bond has a good yield, I'll take it."

Yield is just one of many factors that influence a bond's attractiveness. One factor that can lead to higher yields — often overlooked as a source of risk — is the call option embedded in a callable bond. This feature adds to the risk of a bond investment — and the odds don't always favor the investor. A call option allows the bond issuer to redeem the bond prior to maturity. From an investor's perspective, a call can mean you may own the bond when you *don't* want to keep it and lose the bond when you *do* want to keep it.

When interest rates fall, an issuer will likely refinance its debt by redeeming the old bonds on the call date and issuing new bonds at a lower yield. At this point, the investor no longer owns the higher-yielding security and must reinvest the proceeds at a lower rate. When interest rates rise, an issuer is unlikely to refinance its debt because current financing terms are less favorable. In this case, the investor owns a bond that pays less than the market rate of interest.

In addition, callable bonds have a unique sensitivity to interest rates. As with all bonds, interest rates and prices are inversely related. As interest rates fall, a high-coupon, non-callable bond's interest payments become more valuable, resulting in a higher price. For callable bonds, however, the price appreciation potential may be limited because prospective

Exhibit 4: AMT Bonds' After-Tax Yield

Issue	Rating	Coupon	Maturity	Yield	After-Tax Yield
Port of Seattle, WA	Aa3/A+	4.00%	8-22	2.64%	2.64%
Port of Seattle, WA "Subject to AMT"	Aa3/A+	5.00%	8-22	3.18%	2.29%*

*Assumes Alternative Minimum Tax (AMT) rate of 28%.
Source: Bloomberg

investors know the bond is more likely to be taken away before maturity. As shown in Exhibit 5, a 75 basis-point interest-rate decline from an Arizona school district bond would cause the price to increase by only 1.5%. In contrast, a 75 basis-point interest-rate increase would cause the bond price to fall by 7.8%. The allure of a higher yield can be deceptive, because it can draw attention away from underlying risks and sensitivities that may significantly affect a bond's return behavior.

Investors focused solely on maximizing yields can also overlook the risks inherent in lower-quality bonds; yields are typically higher for a reason. As mentioned in Mistake #2, municipal bond issuers occasionally have difficulty servicing their debt obligations. For example, upon reviewing the existing holdings of a new client, we discovered that a municipal bond issued for an amusement park had defaulted on its obligation to pay. Ultimately, the issuing authority wound up liquidating the assets and made a final one-time payment to bondholders representing a mere 1.2% of the bond's original face value. As examples like this show, bonds don't default often, but when they do, the cost can be substantial. A bond's yield should be just one of many factors to consider when evaluating a particular bond. Nonbiased, specialized portfolio managers can analyze the inherent risk/reward tradeoffs in selecting attractive securities.

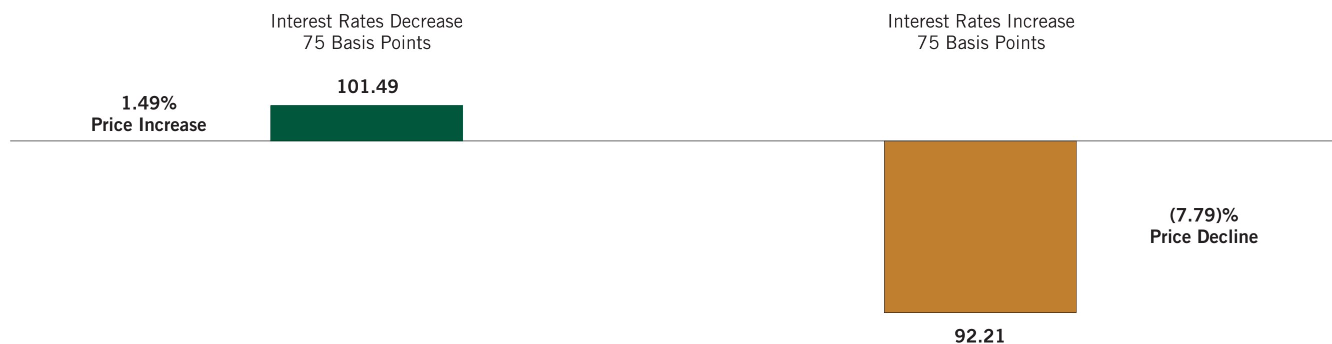
Bessemer's Approach to Municipal Bond Investing

We believe active portfolio management can help maximize returns at a controlled level of risk. To deliver consistent investment performance, we strive to achieve a balance between maximizing tax-exempt income and preserving principal.

Our approach to building municipal bond portfolios begins with a thorough understanding of the current economic landscape, the outlook for inflation, and the developing opportunities and risks across the bond markets. Our expectations for credit quality, interest rates, and the yield curve shape our portfolio strategies. We construct diversified portfolios, concentrating on select securities that we believe offer the greatest return potential at a given risk. As this is a dynamic process, we prefer liquid holdings that allow us to act quickly when new opportunities emerge. In addition, our municipal and taxable bond investment teams sit at the same trading desk and collaborate to adjust clients' holdings in favor of whichever market — whether taxable or tax-exempt — is more attractive on an after-tax basis.

Exhibit 5: Callable Bonds' Price Sensitivity to Interest Rates

Issue	Coupon	Maturity/Call	Price	Yield
DeWitt Arizona School District	2.25%	12-1-24/6-1-14	100.00	2.25%



Source: Bloomberg

Key aspects of our investment process include the following:

Credit analysis. We conduct our own credit analysis independent of ratings agencies and bond insurers, regarding their guarantees and assessments with a healthy dose of skepticism. In our research, we evaluate factors such as the issuer's credit history, sources of revenue, employment base, legal structure, and the quality of its disclosures. Because we aren't dependent on the consensus views, we can often buy undervalued bonds — or sell overvalued ones — before the market has had an opportunity to recognize what our analysis has uncovered.

Relative-value comparisons. We consider a range of investment alternatives — including out-of-state municipal bonds as well as taxable bonds — as we seek to provide an attractive after-tax return and adequate portfolio diversification.

Price scrutiny. We use past and present price comparisons to identify and exploit inefficiencies in the highly variable municipal bond market.

The mission of our team is to uncover the most compelling investment opportunities for clients. We don't have an inventory of bonds to sell, retail mutual funds to market, or sell-side research to pitch. We act only on behalf of our clients, buying and selling in response to specific client needs. Our municipal bond team manages over $7 billion in assets, giving us a strong presence in the market.

Clients benefit from our active bond management approach in two distinct ways:

Informed decisions. Our sophisticated professionals draw on knowledge gleaned from years of experience as they analyze current trends and prices in the complex and highly variable municipal bond market.

Transparent fees. As a team working on behalf of our clients, we negotiate advantageous trades and quote prices without hidden markups.

Our bond portfolio managers work in partnership with your Client Account Manager to understand your personal circumstances. We tailor your portfolios to your unique needs, risk tolerance, and tax status. As always, our goal is to help you achieve your long-term financial objectives.

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