

Know Your Muni Bond Customer

One of the many banes of modern life is customer surveys. Buy a car and the customer service folks will not leave you alone. Call your cable service and you will get some version of the how-did-we-do response. Everyone wants feedback and yet too few seem to know what to do with it once they receive it. “Your call is very important to us...” Yes, I am sure; so just answer it and everyone will walk away happy.

Registered representatives, account executives, financial consultants, investment advisors – deep and sincere apologies to those left of this duplicative list – operate under something called the “know your customer rule.” There are many ways to know your customer; we will ignore both the obvious Biblical one and the one mandated by various money-laundering regulations. You are supposed to know what investments are suitable, “suitable” being something to be judged in hindsight by an arbitration panel if you are unlucky, and you are supposed to have an understanding of what marketing consultants call psychographics, a fancy term for what makes your customer tick.

Let’s focus on this psychographic aspect for the municipal bond market. Municipal bond investors traditionally are driven by an overwhelming desire for safety, for a modest level of current income and above all for a deep and abiding desire to do anything with their money short of dropping it into the mouth of an active volcano rather than pay taxes on it. If you were to sit down with a pencil and sketchpad and draw a portrait of a municipal bond customer, you would no doubt create images out of what was once country club society.

The Power Of Fear

If municipal bond investors are a conservative lot, then their demand for insurance should rise when their supposedly safe investments are at risk. Unlike actively traded Treasuries and somewhat actively traded corporate bonds, municipals are bought and held to maturity more often than not, either in managed portfolios, in both open and closed-end mutual funds and at the shortest maturities, in tax-free money-market funds. For this reason, fear in the municipals does not come from the source seen for Treasuries, higher interest rates. It comes from the same source seen for corporate bonds, credit risk, and from two other sources related to the value of their tax treatment, the effective marginal tax rate and the tax treatment of alternative investments.

The municipal bond environment in 2010 - 2011 provided an almost perfect laboratory to test all of these sources of fear. Not only were various states’ budgets in an absolute shambles from years of living beyond their means and hoping the financial markets would bail them out of their unsustainable public service union pension liabilities, the Bush-era tax cuts were set to expire at the end of 2010. A tax-free municipal bond is worth more at a higher federal tax rate, and many tax-averse investors loaded up on municipal bonds after the 2009 stimulus plan bailed out the states; the bet was these bailouts would continue and tax rates would rise, two factors favorable to municipal bonds.

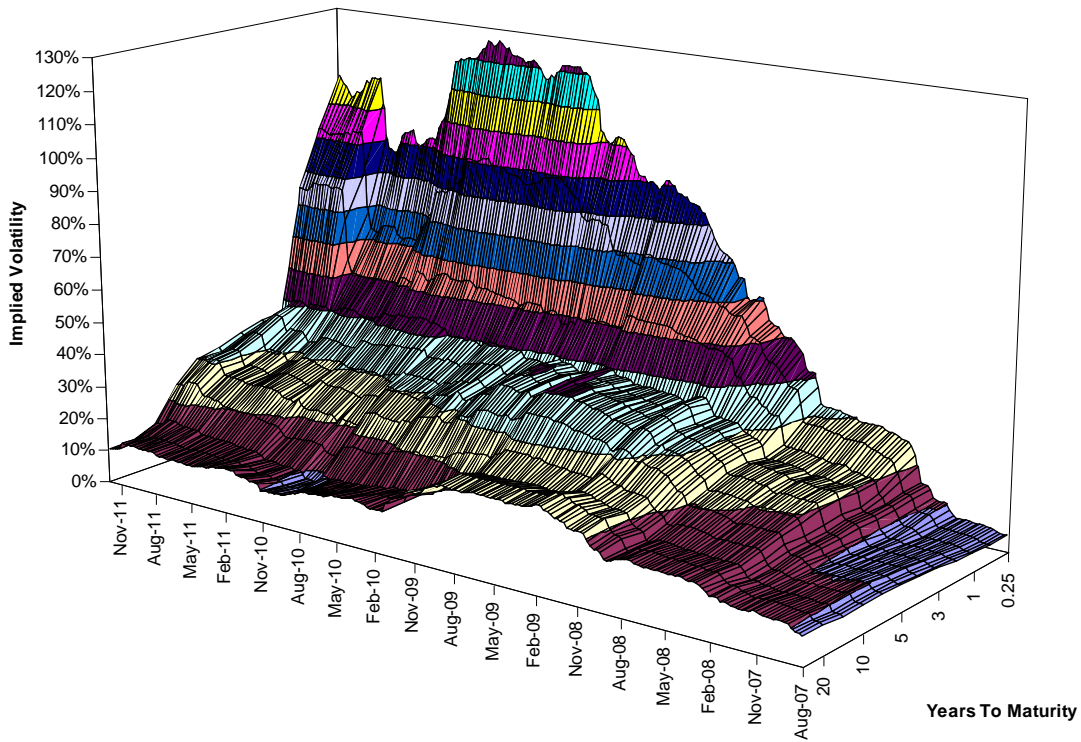
As the 111th Congress dithered on setting tax rates for 2011 until the last weekend of November 2010, municipal bond investors did not know whether they would be avoiding the then-current 35 percent top tax rate, the old 39.6 percent top tax rate or something else altogether. In addition to the federal tax rate on ordinary income, bond investors did not know whether the favorable tax treatment of dividends and capital gains would persist or whether the country would be returning to the more valuable (for bond investors) old tax rates.

Credit Rating And Maturity

Given all of this windup about how skittish municipal bond investors are, you might have expected them to flee the lowest-rated and longest-dated issues first. You would have been wrong on both counts. We can illustrate this with the volatility data that are available for general obligation municipal bond indices ranging in maturity from three months to thirty years and from credit ratings ranging from AAA to BBB. The paths of volatility across the dimensions of time and maturity are illustrated below for three of these indices, AA+, AA and A-. All of the charts will begin at the time of the Federal Reserve’s first rate cut of the credit crunch in August 2007.

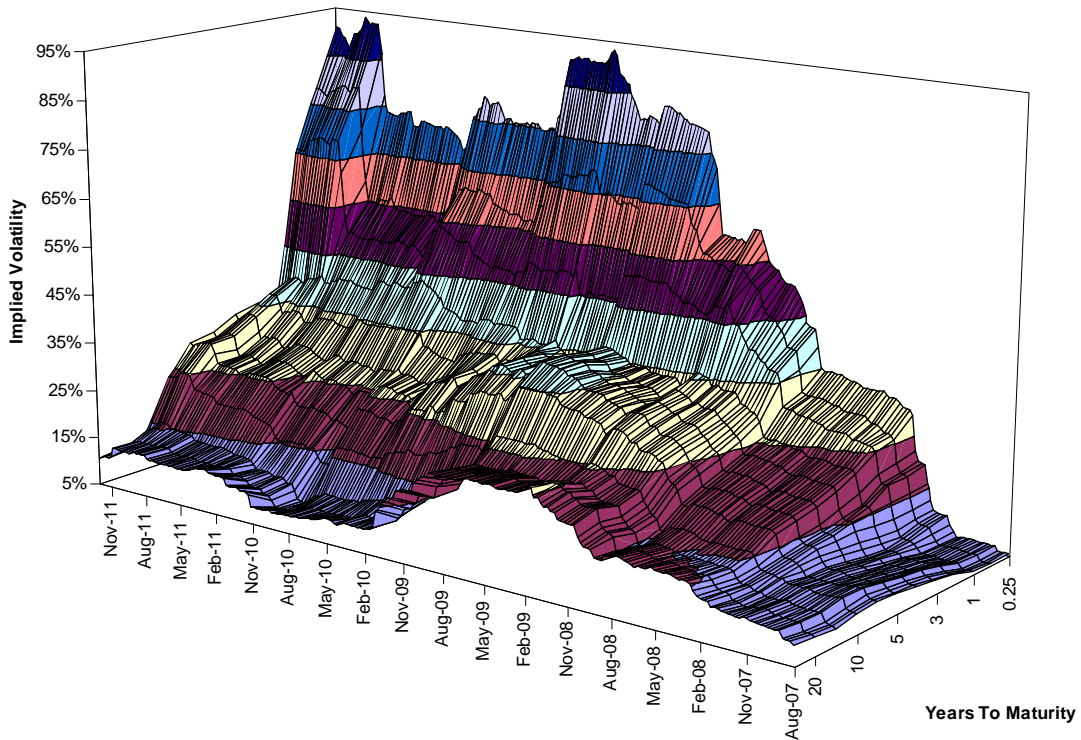
In the case of the AA+ bonds, the short-dated volatility rose rapidly into late 2010, indicating an eagerness on the part of investors to obtain protection on the segment of the market least exposed to both interest rate and credit risk. A similar increase occurred in the late summer and fall of 2011 following the federal debt ceiling debate and the bankruptcies of Harrisburg, Pennsylvania, and Jefferson County, Alabama. Note how stable volatility is at the longer maturities; holders of those long-term bonds were willing to ride over a few scary moments en route to a multiple-decade holding period. It was the investors who were facing position rollover at low short-term rates who were nervous.

General Obligation Municipal Bond Volatility: AA+



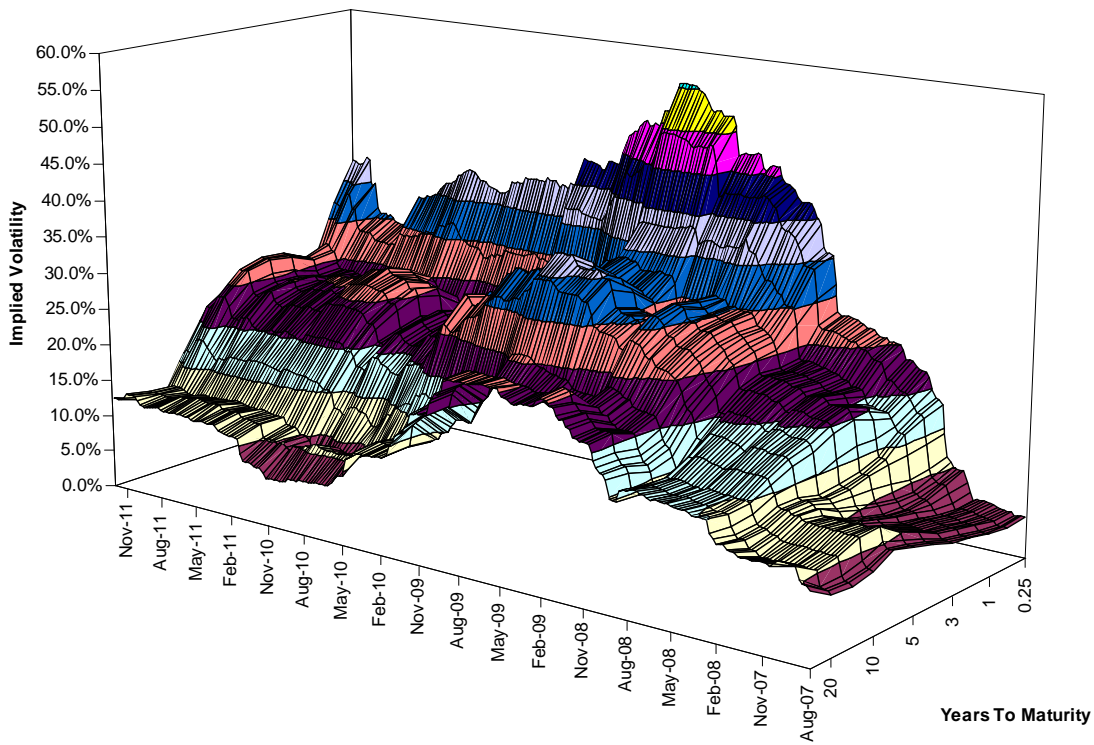
As we move down the credit-quality curve to AA, the risk map starts to change. Here the shortest-maturity volatilities rose most rapidly during 2009, but volatilities turned modestly lower in 2010 before rising with the aforementioned high-profile bankruptcies of 2011.

General Obligation Municipal Bond Volatility: AA



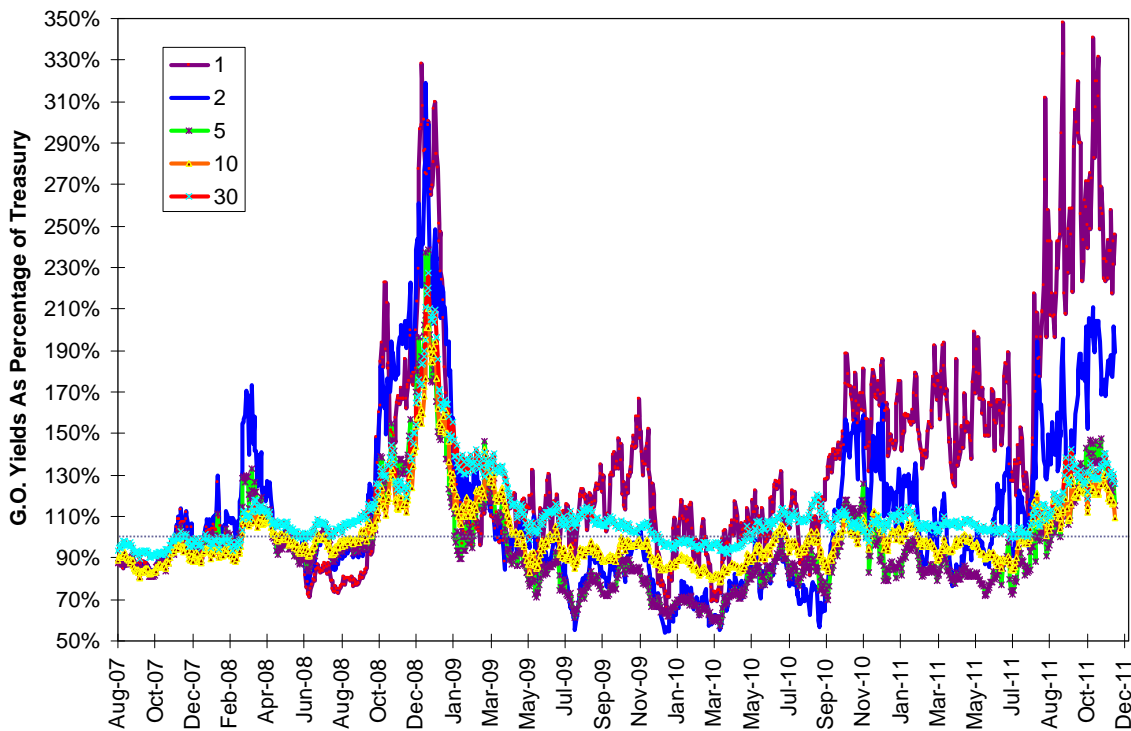
If we move down the credit-quality curve even further, to A-, the picture really changes quite significantly. The short-dated volatilities peaked during the 2008-2009 credit crisis and declined into 2010-2011, while the longer-dated volatilities retain much of their elevated levels well into 2010-2011.

General Obligation Municipal Bond Volatility: A-



An alternative way to look at this behavior is to map the yield of a national index of general obligation municipal bonds as a percentage of Treasury yields. In a perfect world, the municipal bond should yield less; the so-called taxable-equivalent yield of a municipal bond is its yield divided by $(1-T)$, where T is the federal tax rate. This relationship failed to hold spectacularly in 2008's credit crunch. By the time we got to the municipal stresses of 2010 and especially 2011, it was the short-dated bonds, those of one- and two-year maturities, whose yields oscillated violently in relation to Treasury yields.

Municipal Bonds, Taxes And Credit



What can we conclude, then, about municipal bond investors' psychographics? Those who sought safety by buying high-quality and short-dated issues were the most skittish. Their bargain with the market did not include any losses for themselves. If we were to bow to a bond market theory called the preferred habitat model, we would have to say these investors are willing to accept a yield penalty in return for perceived safety.

Investors who owned the longer-dated or lower-quality issues either were content to hold the bonds until maturity in the long-dated case or were perfectly aware they had taken a flyer on some lower-rated issues in the hopes of receiving a little more yield. Some of these bonds might have been held in mutual funds or managed portfolios where the risks were offset by other holdings. This is one of the core principles of modern finance, after all.

Finally, the holders of lower-quality debt may have been making a cynical bet the federal government would come in and rescue them from their bad investments. This would be a variation of what used to be called the "Texas Run" during the savings & loan debacle of the early 1980s: Brokers would seek the riskiest institutions and placed deposits up to the federal insurance limit there in return for higher yield. Pavlov trained dogs to bark; Uncle Sam has trained investors to seek bailouts. But that is a know-your-customer discussion for a different day.