Bond Case Briefs

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Bias in the Municipal Bond Market.

Does a sullied past haunt a bond issuer's future?

In April, something remarkable happened in the otherwise sleepy world of public money. Orange County, Calif., long considered a problem child in local public finance, announced a plan to return to the municipal bond market.

At the start of the 1990s, the county made some big bets on an early form of financial derivatives — not unlike those at the heart of the 2008 financial market crisis — and it lost. It suffered major financial damage and eventually declared bankruptcy. But now the county is looking to borrow once again, and investors are primed to snatch up its new bonds at eye-poppingly high prices.

Financially speaking, Orange County is back in a big way.

The Orange County story illustrates one of the great debates in finance. Municipal bond investors are willing to look past the county's sordid past and focus instead on its financial future, namely its strong balance sheet, solid credit rating and growing tax base. This suggests that investors only care about future cash flows. But don't forget that the county waited 20 years to test the market. Somebody clearly believed it needed a long time to shake its problem-child reputation.

So is the financial past prologue, or not? Some recent evidence suggests that in the municipal bond market — unlike most other capital markets — past perceptions have big financial consequences.

True believers say financial markets are fair because they're forward-looking. If investors focus too much on the past, they'll miss moneymaking opportunities. For instance, if a city lands a big economic development project or renegotiates its pension obligations, then any new bonds it issues should be met with higher demand and sell at higher prices. An investor who fixates on that city's past bond prices will miss out on a surefire investment. So in theory, at least, past prices shouldn't matter.

How does this theory play out in the municipal bond market? In a recent paper I examined how the interest rates on a local government's past bond issues affect the interest rates on its future bond issues. I analyzed data on more than 35,000 "full faith and credit" bonds over the past decade. The results were striking. I found that all else being equal, for every 1 percent increase in a government's past interest rates, the interest rate on its new bonds will be about 10 basis points (or .10 percent) higher. Put differently, past investor perceptions alone account for about 10 percent of current investor perceptions. Behavioral economists call this particular type of bias "anchoring" on past information.

There's bad news and good news here. The bad news is that anchoring is expensive for issuers. On a 25-year, $100 million bond, for example, 10 additional basis points can mean about $4 million in additional interest payments. Consider also that municipal bond interest rates have generally declined over the past decade. This means that many local governments' borrowing costs have been tethered to higher interest rates in the recent past.

This bias is also disconcerting because it’s hard to explain. A cynic might argue that anchoring happens because bond investors are lazy. Instead of carefully evaluating a government’s financial future, they just crib off of past prices. Of course, it’s not that simple. More than 50,000 governments have municipal bonds outstanding, and most of those sell new bonds every few years at most. At the moment there are no federal rules about the timing and content of local governments’ financial reports. In that environment it can be difficult to find recent financial information and even more difficult to find fresh prices on a government’s bonds. Municipal bond investors aren’t lazy. When information is hard to find, they’re just humans subject to bias.

The good news is that finance professionals can take steps to correct that bias. This is yet another reason for local governments to invest in a robust, comprehensive program of public disclosure. As Orange County shows us, it’s important for investors to know where a jurisdiction is, not where it was.

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