Bond Case Briefs

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Bringing Order to Chaos: AI in the Municipal Bond Market

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By some estimates, there are over one million fixed-income securities issued by U.S. state and local governments to fund projects like schools, highways, and utilities. Each of these securities has unique tax treatment, credit ratings, and yield structures. They primarily trade in an "over-th--counter (OTC) " market with transactions occurring directly between parties rather than on centralized exchanges.

This decentralized structure leads to less frequent trading, as many investors adopt a "buy and hold" strategy, resulting in few daily trades. Some bonds are even less liquid, trading only by appointment. This means they don't trade continuously like stocks. Instead, trades occur when a buyer and a seller agree on a price, which can happen sporadically. Because they trade OTC, pricing is determined through negotiation rather than a centralized exchange.

Each municipal bond has unique characteristics – issuers, maturities, credit ratings, and potential tax treatments – making price discovery more challenging than for liquid, standardized securities like Treasuries. Unlike corporate bonds, municipal issuers follow different accounting standards, making financial comparisons difficult. Legal protections for bondholders vary by state, and political factors like pension liabilities and tax policies impact creditworthiness. This structure has historically led to wide bid-ask spreads, meaning the difference between what buyers pay and what sellers want can be larger. Most municipal bond trades require an intermediary, such as a broker, to facilitate transactions. Investors looking to buy or sell municipal bonds must often work with brokers, and buy on the offer, rather than executing trades instantly.

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by John Sweeney, 2/24/25