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Muni Managers Unearth Secondary Market for Price Discovery.

Some municipal fund managers are finding it's possible to use the secondary market to help determine fair bond pricing after a drop in new issuance has limited their reliance on the primary market as a benchmark.

While many market participants prefer to gauge prices in the secondary market against large, recognizable, liquid new issues, they said current secondary trading levels and trade history provide a reasonable alternative, thanks to strong demand for paper.

"There is enough going on in the secondary market for reasonable price discovery," said Jim Colby, chief municipal strategist at Van Eck Global, in an interview Aug. 28. Price discovery in the secondary market often comes via the strength of the bid-offered side of the market - which Colby described as "pretty firm" from June through last week. "If we are evidencing demand by searching for bonds, that's every bit an effective and an important way of determining value," he said.

Long term bond issuance has declined 12% this year through August to \$203.25 billion, according to Thomson Reuters figures, even after increases in two of the last three months. At the same time demand for tax-free yields has propelled inflows into muni funds for much of the year, including an eight week stretch through Sept. 3, according to Lipper FMI.

"Secondary market price discovery is not necessarily difficult because customers who are putting bonds out for the bid are getting pretty decent numbers," a New York trader at a Wall Street firm said. "It's hard to keep bonds on the shelf."

New issuance of familiar names is what really aids price discovery and establishes a benchmark, Colby said.

"When it's Texas, California, or New York, those issuers are trend-setters or market-setters in terms of valuation - everybody will readjust their views based on what those scales look like," Colby said.

"Those not involved on a day to day basis might think less of that process, but I'm looking for a big New York State or Maryland deal to be representative" of value, Colby said.

The New York trader agreed that most municipal participants view the primary market as the main driver of the municipal industry, when it comes to pricing and establishing relatively attractive levels to entice investors. "Most deals have been well-received and have later traded up in the secondary," the trader said.

"If there's a lot of relative value in the primary, investors will forgo the secondary," where he said higher prices can sometimes prevail in the absence of healthy new issue volume, the trader said.

Some participants, meanwhile, prefer to negotiate for what they deem a fair price in the secondary market based on recent trade history, thereby, creating the two-way, bid-wanted and bid-offered

sides of the secondary market.

“There is a basis for narrowing down some sort of value and I think that can happen on any given day” in the secondary market – even when new issuance is lackluster, Colby said.

Others said price discovery and value in the secondary has recently been possible due to the strong investor appetite for municipal bonds and steady support from the bid-offered side of the market at a time when new issuance has lagged.

“I think with the Street not heavy and with last week clearly having a holiday feel and not a lot of issuance, it’s not necessarily difficult finding a bid for bonds,” the New York trader said.

“The market is pretty apathetic after last week,” he said on Tuesday, referring to the post-Labor Day market climate.

Meanwhile, the pace of the new-issue market often affects ebbs and flows of the secondary market, experts said.

“To the extent the volume is lower on the new-issue side, it tends to slow down activity in the secondary,” said Tom Dalpiaz, managing director at Granite Springs Asset Management LLC said in an interview on Thursday. “When new issuance is robust and there’s a lot of deals you tend to see more things out for the bid in the secondary market as people sell bonds to make room for new issues.”

He said traders, analysts, and investors are still able to uncover value in the secondary in the absence of large, benchmark deals in the primary market.

“When big deals are priced – people view it somewhat as a benchmark for levels, but with diligence you can find some good value in the secondary,” Dalpiaz said in an interview on Thursday.

Dalpiaz is part of a team that manages \$200 million in total assets under management, two-thirds of which is municipal assets.

He focuses much of his attention in the secondary market, and said he tries to analyze comparisons to big new issues in the primary market -if and when available.

“The new issue market is a sign post which can be very active, or very quiet, but the secondary market grinds along and goes about its business,” regardless of the pulse of the primary market, Dalpiaz said.

In fact, many portfolio managers that do heavy credit surveillance, he said, are often less reliant on the “deal of the week” in the primary and are more accustomed to “looking under every rock” to reveal value in the secondary, Dalpiaz said.

In addition, many municipal players also use the benchmark scales published by Municipal Market Data to gauge the accuracy of pricing and value in the secondary market on a daily basis, managers said.

Others take their cue from municipal pricing and valuation services, like Interactive Data Corp. and Standard & Poor’s Securities Evaluation, often known by its original branding, J.J. Kenny, sources said.

IDC offer millions of independent evaluations of fixed income securities, while Standard & Poors

Securities Evaluation offers advisory services, including evaluated pricing and model valuation of fixed-income securities.

The Municipal Securities Rulemaking Board also offers a price discovery tool on EMMA that allows retail investors to view the prices and yields of up to five securities in a side-by-side comparison, as well as daily highs and lows trading trends in a move that satisfies regulators' demand for more price transparency.

"Secondary market trading has flurries and moments of activity when new deals have come into the marketplace," Colby said. "Traders have supported that after-market activity and are very supportive of sellers looking to reposition or raise cash for new issues."

In addition, he said sellers can feel "pretty confident" putting bonds out for bid when they know there's not going to be "a wave of bonds coming into the new-issue marketplace that diminishes the bid side."

Dan Heckman, senior fixed income strategist at U.S. Bank Wealth Management, said investors can either use historical data to gauge the price and valuation of a bond, or use the new issue market as a benchmark.

"We would probably prefer price discovery via where new issues are," he said in an Aug. 29th interview. "We shy away from just solely accepting pricing in the secondary market [as a gauge of value] - unless we know what someone paid for it."

"We certainly would want to look at other benchmarks, like the new-issue market, because you can look at new issues today, yesterday, and last week that are pretty current as a better way of how pricing can get done," Heckman said.

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