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Muni Quirk Offers Free Money Over Treasuries With Same Guarantee.

Pre-refunded munis, which are tax-exempt bonds whose repayment is guaranteed by holdings of U.S. government debt, yield about 0.9 percent on average, the same as similar-maturity Treasuries, Bank of America Merrill Lynch index data show. The munis typically yield less than Treasuries because investors aren't taxed on the income. In February, the gap was as much as 0.26 percentage point.

That difference disappeared for the first time in 17 months after a jump in refinancings caused muni prices to tumble. Bank of America and Municipal Market Analytics recommend buying pre-refunded munis, anticipating they will outperform and provide a hedge against bond-market losses as the Federal Reserve prepares to raise interest rates.

"This is a way for people who want Treasury credit to buy it extremely cheap," said Phil Fischer, head of muni research at Bank of America in New York. "There are a lot of investors who are concerned that rates are going to rise. You have the benefit of tax-exempt revenue on a Treasury bond."

Bond Rout

U.S. government-bond investors have lost more than $195 billion since mid-April on speculation borrowing costs will increase. Fed Chair Janet Yellen said Wednesday that investors "could see a sharp jump in long-term rates" once the central bank raises its benchmark rate from near zero, where it's been since 2008.

The slide in the price of pre-refunded munis relative to Treasuries is the result of a rush by states and localities to borrow while interest rates are still close to five-decade lows. They've issued $145 billion of debt in 2015, the most to start a year since at least 2003, when Bloomberg data begin. More than two-thirds of the deals have refinanced higher-cost debt, an amount not seen in more than two decades.

Pre-refunded bonds are created by advance refundings, which allow municipalities to refinance securities before their call dates. Municipalities sell bonds and use the proceeds to buy Treasuries or other federally backed debt. The income from the government securities is used to pay off the higher-cost munis as they mature.

The refinanced bonds typically gain in price because repayment is assured. Moody's Investors Service even has a separate rating for debt backed by escrow funds holding U.S.- guaranteed obligations: #Aaa. A rally hasn't happened because public officials have saturated the market with debt.

Honolulu Haven

Pre-refunded Honolulu bonds maturing in July 2018 traded last month at an average yield of 0.95 percent, data compiled by Bloomberg show. Treasury notes with the same maturity traded at a 0.96

percent yield.

The comparable yields mask the fact that the interest rate on the municipal bond is equivalent to 1.68 percent on taxable debt for those in the highest federal tax bracket.

That differential should provide a buffer for investors if fixed-income yields continue to rise, Municipal Market Analytics, a Concord, Massachusetts-based advisory firm, said in a May 4 report. Even if rates don't increase, pre-refunded bonds will probably rally as market demand catches up with the pace of issuance, according to the report.

Ten-year Treasuries yield about 2.23 percent, compared with about 2.2 percent for benchmark munis.

"From a relative value standpoint, why not buy a pre-re?" said Dawn Mangerson, who helps oversee $8 billion of munis at McDonnell Investment Management in Oakbrook Terrace, Illinois. "There's no credit risk. They got cheap."

Bloomberg

by Brian Chappatta

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