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Rising Rate Fears Live On as Pimco, Vanguard Pass Over 4% Munis.

For municipal-bond buyers, sometimes it's not all about yields.

In California's $3 billion general-obligation debt sale last month, it offered two bonds with identical 20-year maturities. One segment yielded 3.24 percent; the other, 2.89 percent. Why the discrepancy? The higher-yielding bonds pay annual interest of 4 percent, a full percentage point less, making them a risky bet that interest rates won't rise significantly over the next decade, according to money managers at AllianceBernstein Holding LP, Pacific Investment Management Co. and Vanguard Group Inc.

Yield-starved investors have few other alternatives as tax-exempt interest rates remain near generational lows, which has left the smaller-coupon securities selling at a comparative discount amid speculation that borrowing costs have nowhere to go but up. Extending maturities isn't alluring: the difference between 2- and 30-year tax-exempt debt is the lowest since 2008. Nor is taking on more risk: the extra yield received from BBB instead of AAA rated debt is near the smallest in at least three years.

"In the bond fund space, as a way to pick up additional yield, there's been a larger appetite for going down to 4 percent coupons," said Chris Alwine, head of municipals in Malvern, Pennsylvania, at Vanguard, which holds $157 billion of the securities. "That strategy will do OK as long as rates remain range-bound, but we're going to be very selective."

The divergent yields on bonds with identical maturities stems in part from quirks in the $3.7 trillion municipal market, where most securities give the issuer the option to call them back before they're due, usually after 10 years, in case they can be refinanced at a lower cost. In the corporate market, by contrast, the debt is more likely to remain outstanding until maturity.

States and cities have almost always exercised that buyback option because interest rates have been largely on the decline since the 1980s. In 20 of the past 30 years, yields on long-dated general-obligation bonds ended lower than where they started, according to a Bond Buyer index.

If they went up significantly, which would cause prices to fall, some securities — particularly those with lower coupons — probably wouldn't be called, leaving investors forced to sell at a loss or hold them until maturity.

"The question is do you pick up enough yield to compensate for that extension risk?" said Guy Davidson, who oversees $33 billion as director of municipal fixed-income in New York at AllianceBernstein. He said in many cases, the answer is no. "You should pick up yield to go down in coupon, because obviously if yields rose, it has a better chance of extending to its maturity."

The California deal offered an additional 0.35 percentage point on debt due in 2036 with a 4 percent coupon rather than 5 percent. The Los Angeles Unified School District last month issued two sets of 2040 bonds with those interest rates at the same spread. So did Massachusetts, on general

obligations maturing in 2041.

‘Price Cliff’

For David Hammer, co-head of municipals at Pimco, that difference isn’t enough. That’s because of another market quirk, known as the de minimis rule, that limits the tax break for owners of state and local debt.

When they buy tax-exempt bonds at a deep discount to 100 cents on the dollar, or par, any price gains are subject to the income-tax, not the lower capital-gains levy that usually applies. Coupon payments remain tax free.

That price discount, which Pimco estimates to be 97.5 cents for a 10-year bond issued at par, is called the de minimis threshold. Crossing it creates a “price cliff,” according to the firm, because the bond will keep dropping until the yield rises enough to offset the additional taxes.

If interest rates jump, causing the value of outstanding securities to fall, those with the lowest coupons would be the first to breach the de minimis limit.

In Connecticut’s bond sale last month, for example, 4 percent debt due in 2034 priced at 105 cents, compared with 115.8 cents for 5 percent bonds. At those prices, it takes a smaller increase in interest rates to invoke the de minimis rule on the 4 percent bonds and raises the odds that investors will be holding the debt past its call date.

Even with a patient Federal Reserve — which has held off since it’s initial increase in December — that’s not a risk Hammer said he’s willing to take.

“Lower coupons in this grab for yield have become overvalued,” said Hammer, who oversees $45 billion of municipals in New York at Pimco. “Even in an environment where rates are lower for longer, if you’re not being compensated for that additional duration risk, it’s not a trade that I think will work out very well over time.”

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