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Muni Bond Leverage: Risk vs. Reward of Tender Option Bonds.

Municipal bond funds are a very popular investment that provides its shareholders with a diversified portfolio of municipal bonds.

Typically, investors use muni bond funds to provide tax-free income with a secondary goal of preservation of capital. Muni bond funds can be very specific in their selection of portfolio holdings, like only of a certain investment grade from a specific state or maturity. Therefore, muni bond funds have been known to be a relatively conservative for the average investor.

However, some municipal bond funds have implemented leverage within the portfolio in an effort to increase returns, whether in the form of distributions or through total return. It is to be noted that with more leverage comes added risk to the portfolio and its shareholders. Let us explore this concept in more detail in the following sections.

Tender Option Bonds Structure

A way for municipal bond managers to acquire leverage is by using tender option bonds (TOBs). Tender option bonds are a structured product held in the form of a trust fund. The municipal bond manager deposits some of its high-quality municipal bonds to fund the tender option bond trust. Then the TOB trust issues two types of securities: short-term floating rate and inverse floating rate investments. The short-term floating rate investments are then sold to money market funds that are looking for high-quality short-term investments. In exchange for the short-term investments, the money market funds pay cash directly back into the muni bond fund. This can be better understood from the flowchart shown below.

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