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Regulator Warns of Interest-Rate Risk Retail Investors Take With Low-Coupon Munis.

MSRB study shows retail investors purchase more 3-3.5% coupon bonds, institutional buy 5%

Retail investors purchase more municipal bonds with lower coupons than institutional investors do, setting themselves up to take a hit if interest rates rise, a regulatory organization found in a recent study.

Earlier this week, the Municipal Securities Rulemaking Board released a study showing that more than half of retail investor purchases involved bonds with a coupon of 3% to 3.5%. Most institutional investors bought bonds with a 5% coupon. The analysis was based on sales of bonds with maturities of 15 years or longer between May 1 and Oct. 1 last year.

In the report, the MSRB highlights the interest-rate gamble that retail investors are taking if they sell their bonds before they mature. If rates rise, bond prices fall. The smaller the coupon, the more vulnerable the bond is to rate volatility.

“In particular, a potential future rise in interest rates could have a material impact on investors’ ability to sell the bonds at market price, should they want to sell the bonds prior to maturity,” the report states.

In addition, the market discount is more likely to fall outside a de minimis threshold and be taxed at the ordinary income tax rate rather than at the capital gains rate, which would likely drive the bond price lower.

The report is a way for the MSRB — a self-regulatory organization that focuses on rule-making, education and transparency — to help investors navigate the muni bond market, said John Bagley, chief market structure officer for the MSRB.

“We want to make sure investors have all the information available at the time they’re making these decisions,” Mr. Bagley said. “If you’re looking at [low-coupon] bonds, recognize that this is a unique risk to this type of structure.”

Ronald Bernardi, chief executive of Bernardi Securities, endorsed the MSRB report because it highlights the risks surrounding low-coupon bonds.

“I like that the MSRB puts these pieces out,” Mr. Bernardi said. “Bonds are complicated. The report is good. It’s basic. That’s the audience the MSRB is addressing. There are a lot of sophisticated investors out there who are buying bonds themselves.”

But he hopes the MSRB study doesn’t stigmatize low-coupon bonds.

“My one concern with this is don’t conclude from it that a bond with a 3% to 3.5% coupon, within the context of the entire portfolio, is necessarily a bad thing," he said.

Mr. Bagley said the report is not meant to indicate that investors are being harmed by purchasing low-coupon bonds or that they should avoid them. The report notes that buyers may want to take advantage of lower premiums and potentially higher yields.

But financial advisers who recommend discounted bonds also need to know the risk, Mr. Bagley said. "They should be aware of it and telling their clients about this risk when their clients buy bonds."

Financial advisers already have a good grasp of the ups and downs of the bond market, said Dennis Nolte, vice president at Seacoast Investment Services. He recently attended a Financial Planning Association of Central Florida meeting about tax-free income, where municipal bonds were a topic of discussion.

"There aren't too many folks who have just fallen off the turnip truck," Mr. Nolte said. "The garden-variety financial adviser has a grasp of the risks in the market when you're buying an investment with a long duration."

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BY MARK SCHOEFF JR.

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