NAMA NOTABLE NEWS

NATIONAL ASSOCIATION OF MUNICIPAL ADVISORS

THE PROS AND CONS OF PREMIUM BONDS

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When it comes to the pricing of municipal issues, there are two standard alternatives: high-coupon (5%) bonds sold at a substantial premium over par, or much lower coupon bonds sold close to par. Why this difference?

Premium bonds are targeted at institutional investors, while par bonds are aimed at retail. There are two basic reasons for the appeal of premium bonds to institutional buyers. If they are eligible for advance refunding, there is a high likelihood that they will be refunded and thus rated AAA, with a commensurate increase of price. A related consideration is that because issuers rely on simplistic refunding rules, such as 3% NPV savings, they tend to refund prematurely. In doing so, they effectively transfer option value to the investors. Advance refunding is also desirable from a risk management perspective, because it guarantees that the bonds will be called.

The second appeal of premium bonds is that they are certain to outperform discounts when rates rise. Institutional portfolios, such as mutual funds and ETF's, are 'marked to market'. When rates increase all bond prices fall; however the prices of discount bonds fall disproportionally more than those of premiums. The reason is unfavorable tax treatment: the gain resulting from a below-par purchase is taxed at maturity as ordinary income. For example, if you buy a bond in the secondary market for 90, you will have a 4 point tax liability (40% of 10). Institutional investors are obviously cognizant of this phenomenon, which further depresses the prices of discount bonds. As an aside, municipal advisors should be aware that bond analytics offered on commercial platforms fail to incorporate this tax effect, and therefore underestimate the potential damage due to rising rates. (See Muni Risk, for the correct calculation of interest rate sensitivity of discount bonds.)

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ANNOUNCEMENT

NAMA, it's official! All CIPFAs are now CIPMAs.

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ADDITIONAL UPDATES

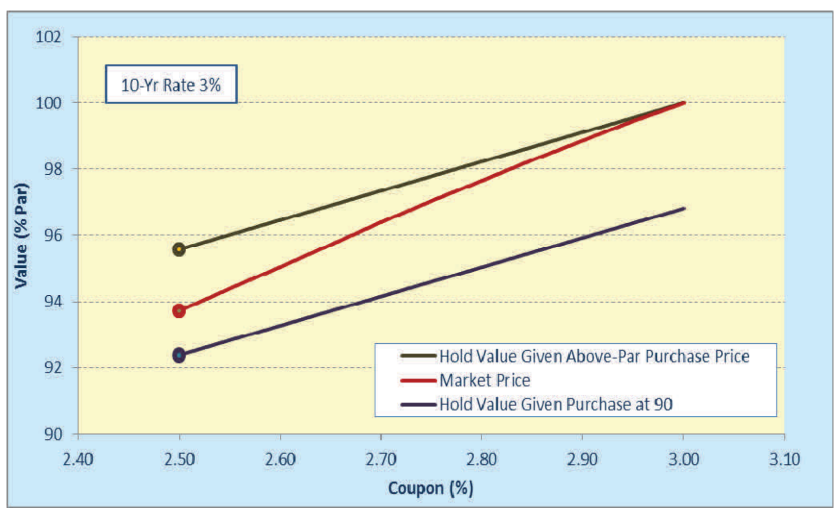
- All CIPMA's due to have their CEUs submitted this year need to do so by March 31. Emails will be sent the week of February 2nd to those individuals who are due and their firm representatives.
- As a reminder, with the change from NAIPFA to NAMA, the professional designation has changed as well. It is now CIPMA, Certified Independent Professional Municipal Advisor. At this time, CEUs will remain the same at 36 hours every three years. **Be sure to change your certification on your letterhead, email signature and business cards. You worked hard for that designation, advertise it proudly!**
- Effective January 1, the new website address is www.municipaladvisors.org. There were long discussions at many Board Meetings regarding the URL and ultimately it was felt that this is the most representative of the organization and would easily be recognized on the web. Additionally, Roseanne Hoban, the NAMA Executive Director has also updated her email address. It is now rhoban@municipaladvisors.org. Lastly, the Google group email address has changed for group messaging to the membership. If you are interested in sending an email to the firm membership for discussion, please address the email to municipaladvisors@googlegroups.com.
- A reminder that annual dues invoices have been mailed and are due by February 28. For ease of payment, you can pay your dues invoice online using a credit card after February 2. Checks may be mailed to the NAMA headquarters office.
- MSRB and Municipal Advisory Council of Texas Education and Outreach Seminar — March 5, 2015 at 3:00p.m. ET. Visit www.msrb.org to register.

THE PROS AND CONS OF PREMIUM BONDS CONTINUED...

Let's turn to 'current coupon' bonds. They are preferred by individual investors who loathe paying much above par, even though the higher coupon would provide adequate compensation for the premium. A different reason for avoiding premium bonds is that, in the unlikely event of a default, the collateral would be based on the par value rather than the bond's basis.

Market prices are less important for individuals, who tend to be 'buy and hold' investors, than for institutions. Given the wide bid-ask spreads for small-size deals, they should indeed stay out of the secondary market. Also, individuals focus on cashflow and pay less attention to market performance. This is just as well in the case of a discount muni, whose market price is less than its worth to the holder. Why so? Recall that the market price encompasses the eventual tax payable by the new buyer. But an investor who purchased the same bond at par has no such tax liability. Thus the 'hold value' of the bond will exceed the market price by the present value of the tax on the gain. This difference can be significant, as shown in the following exhibit.

Hold Value and Market Price Can Differ Significantly



In summary, premium bonds offer several advantages to institutional investors. Should such bonds be advance-refunded, their value increases because the refunded bond is backed by Treasury or agency bonds held in escrow as part of the process. In addition, premium bonds are less sensitive to rising rates than discount bonds — useful because institutional investors' returns are based on mark-to-market. On the other hand, retail investors tend to buy and hold and are less concerned with fluctuation in market price. They are averse to paying a premium even if it is fair compensation for a higher coupon.