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The Basic Concepts of Municipal Bonds

Henry Dormitzer, senior portfolio manager of Choate Investment Advisors, is joined by Anson Clough, managing director of Appleton Partners, and Nathan Harris, co-director of municipal research of Appleton Partners, to discuss all things municipal bonds.

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Transcript

Henry Dormitzer: This is Henry Dormitzer and I am a senior portfolio manager of Choate Investment Advisors. Today, we will be talking about municipal bonds with Appleton Partners. Appleton is a 100% employee-owned company founded in 1986 that manages $11.4 billion in assets. Ten and a half billion dollars of those assets are bonds and 9.6 billion of those assets are municipal bonds. We will be talking today with Anson Clough and Nathan Harris. Anson has 26 years of experience in the municipal bond market. At Appleton, he oversees responsibility from portfolio management, trading and research. He is the co-head of fixed income investments. He started his career at Scudder Kemper Investments in municipal bonds and has been doing it ever since.

Nathan Harris started his career at Standish Mellon Asset Management. He is the past president of the Boston Municipal Analysts Forum and he is Appleton's co-director of municipal research.

Nate and Anson, I am so happy to have you with us.

Anson Clough: Thanks, Henry. We are happy to be here today.

Nathan Harris: Yes, thank you, Henry. We are excited to be here.

Henry Dormitzer: We are going to start with a broad discussion about what is a municipal bond. Who issues it, and what makes it different than corporate bonds.

I think that is a topic that people are going to find really interesting. We talk about it in generalities often. So, let's get into some of

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the details. I wanted to start asking you, Nate. Who issues municipal bonds?

Nathan Harris: Thanks, Henry. Primarily the municipal market represents states, local governments and in that we would include counties, cities, towns, and school districts. It also includes municipal agencies. Those that provide water, sewer, public power. In addition, there are providers of the central service so: airports, highways, public transportation; all entities that are eligible to issue within the municipal bond market. We would also point out that – certain non-profits are eligible to access the municipal market. Those would include: hospitals, higher education and even some foundations. While these issuers that I just name preside the bulk of the municipal market and represent the majority of taxes and bonds outstanding, we would be remiss if we didn't also point out that in some limited cases, some entities that are full profit actually can issue municipal bonds. This will include corporations and if the underlying project needs certain public benefit thresholds, but those types of incidents are much limited and typically are outside of what a typical municipal bond portfolio would include.

Henry Dormitzer: I think that is interesting. I would point out that means a municipal bond could be issued by Harvard University or maybe the parent entity of Mass General Hospital or the State of Vermont. It could run a wide range, or the toll authority, the Massachusetts Turnpike Authority.

So, I started my introduction, Nate, by saying that municipal bonds are fundamentally different than corporate bonds. I was wondering if you could talk us through why that is true.

Nathan Harris: The difference between a municipality and a corporation is really why a municipality is in existence versus the goals of an actual corporation. A municipality is a preputial entity and it needs to be a concern as the demand for essential services continues throughout any different type of scenario. I think that is important in the current environment with an economic downturn and stay at home orders. There is still a demand for essential government services such as transportation, education, social services, health care and safety. This essentiality also breathes resiliency. We've seen during difficult economic remission, municipality finds support from its stakeholders. Those stakeholders being the citizens, employees, bond holders and even higher levels of government. Now on the corporation side, certainly there aims to be a growing concern but there are certain instances where they have much weaker control over their outside influences. Certainly now the difference would be for a corporation is certainly they aim to be a going concern, but their ability to raise revenue, adjust their expenses, keep their business going can be significantly influenced by outside factors that are out of their control. Ultimately, there is a potential for stopping of business and potential liquidation. That cannot happen in a municipality, a municipality means to be a going concern and provide those essential services throughout.

Henry Dormitzer: I think the last point you made is really critical, Nate – that companies can stop, they can become insolvent and they can go away. The consequence of a company going away, I guess is that, the equity, the people who own the company just lose their equity and it shuts down and goes away. A state government cannot go away. There is no equity ownership of the state or government; it is there to be there forever and to support the operations of the state. Similarly, I bet you would tell us that in bankruptcy companies often have to pay off all their debts. And there's no bankruptcy for state governments. Talk to us a little about how governments – or municipalities I should say because not all municipal bonds are government-issued – how municipalities pledge money to repay debt?

Nathan Harris: So at a very high level, we can actually split the municipal market into two broad categories when it comes to pledges or how they repay their municipal bonds. That would be general obligations, or revenue bonds. For a general obligation, typically these would be issued by a state or local government. In a very high level an obligation or a promise to repay those bonds, now we can definitely get into deeper provisions of that security. In often times, the revenues that are backing a GO are actually pledged, but it typically consists of, at the state level, it would be income taxes or sales taxes or corporation taxes. On the local level, generally speaking, it's property taxes. A general obligation is a pledge of that entity to do whatever it needs to make sure that it is honoring its debt obligations. On the revenue side, it is much more specific in that an issuer such as a toll road or an airport is dedicating specific revenue sources to the repayment of the bonds. For a toll road, it would be exactly what you would think – it's the revenues that buy that entity, in other words, fares collected by vehicles traveling on the road. In an airport, it would be fees received from airlines, fees paid by passengers as well in some cases, revenues or fees that are earned by concessions within the gates and in the terminals. As far as looking at the security provisions, it is very straightforward for a revenue bond of what is the revenue source and how is that going to be used to repay that obligation.

Henry Dormitzer: So, Nate, let me put you on the spot a little bit on this. Give me an example of general obligation bond issuers.

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Nathan Harris: Absolutely, so at the state level, it would be the state of Massachusetts issues general obligations laws. For the state of Massachusetts, they have not exactly pointed out what tax revenues are pledged to bondholders, but they are looking at the entire basket of the state's income tax, sales tax and other fees that they collect. At the local level, it would be within Massachusetts, it would the city of Boston, and they've pledged in that instance – although it is a general obligation and they pledged to do whatever it takes, and also specifically pledged the property tax revenues that they levy on their residence and commercial businesses within the city's boundaries.

Henry Dormitzer: Right, so the Commonwealth has lots of different revenue sources and they pledge to use some of all that to pay back their debt. Boston has fewer but property taxes is their biggest one and they use those to pay back the debt.

Nathan Harris: Exactly, and within Boston, although that is specifically pledged, and this goes for other local government, they also have the ability to use whatever else is available to make sure they honor their obligation.

Henry Dormitzer: So let's talk about a revenue bond and how that is different. Pick a revenue bond issuer that we can call out on this discussion.

Nathan Harris: Sure, and for a good example, and you had mentioned it earlier, Massachusetts Turnpike, the Massachusetts Highway system has revenue bonds outstanding. The back behind that is the tolls that are as of now collected electronically, but it is tolls that are collected on each passenger, a commercial vehicle that travels along that turnpike day in and day out so those revenues are collected by the Authority. They are used to pay expenses, but they are also dedicated in most instances first to pay off their municipal bonds.

Henry Dormitzer: I am going to ask you a question that I may not even know the answer to, you have to make sure I am right on this. When Harvard borrows money, or when a hospital borrows money, are those general obligations of the hospital system or the general obligation of the college.

Nathan Harris: That is a tricky question but a good question, Henry. Generally for higher education, although they often get lumped within revenue bonds, we would actually categorize them as a general obligation because in Harvard University's instances, they are not specifically just pledging tuition, or just pledging fees they receive in their room and board. They have guaranteed their bonds by offering whatever available resources are to make good on their debt payment. In a healthcare situation, that would be more specific because the revenues are providing healthcare services to patients.

Henry Dormitzer: That's great Nate, we just covered one in a big way that municipal bonds are unique. They are just different than corporate bonds. The nature of the pledge, the nature of the borrowers fundamentally, existentially you could say different than a corporation. But there is another major way that municipal bonds are different than corporate bonds. I am going to Anson to talk to us about tax exemption because that is a big difference.

Anson Clough: Sure, Henry. Tax exemption is a big thing for municipal bonds, it is a very important facet of what makes municipal bonds so attractive to investors. Specifically, municipal debt is tax exempt at the federal level and income earned by municipal bonds are tax exempt within the states those bonds are issued. For example, the state of Massachusetts GO bond income earned on that particular bond would be state tax exempt for those residing in the state of Massachusetts. Investors outside Massachusetts would be paying income tax on those bonds if they reside in a state that does have an income tax. Conversely, if you bought a Texas GO bond and you were a state of Massachusetts resident, you would pay income tax on the income earned on that Texas bond.

Henry Dormitzer: So, let me just clarify because I think I have it. But, if a Massachusetts resident buys a Texas bond, the Massachusetts resident doesn't pay federal income tax on the income, but does pay Massachusetts income tax on the income.

Anson Clough: Absolutely, spot on.

Henry Dormitzer: I have another one for you to follow up because what you said earlier was income on the bonds is exempt from taxation at least from federal taxation and may be from state taxation. What about capital gains? I buy a bond at a low price and sell it at a high price. Is that exempt?

Anson Clough: No, that is not – it is actually going to be subject to the federal capital gains rules as well as any specific capital gains rules within your state.

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Henry Dormitzer: So, then, I would imagine that – if I am an investor and I buy a muni bond, and I don't have to pay federal income tax on it and my federal income tax is something like 35% somewhere around there, would I be willing to earn less on a municipal bond than I would want to earn on a corporate bond because I don't have to pay taxes on the income.

Anson Clough: Absolutely, so municipalities, by having that benefit of tax exemption, technically, are subject to lower borrowing costs and that is the attraction for municipalities to be borrowing at a municipal universe. Investors are willing to take a lower yield, a lower cost to invest in the municipal universe. So, their borrowing costs are much lower in the tax exempt universe.

Henry Dormitzer: So, a term that we often hear – traders in the municipal bond space talk about is the ratio. I think they mean by that, but you can tell us. What is the ratio of the interest rate earned on municipalities to the interest rate earned on other taxable bonds? Can you tell us what the ratio means?

Anson Clough: Absolutely, so when we look from an investment standpoint, we look at what the actual yield on a particular bond is relative to a benchmark. In this case, a great benchmark is a US Treasury yield. So, quite often we will look at our investment universe based on the AAA yield curve and how that yield curve is pricing relative to comparable treasuries. So, we will take the AAA municipal yield curve in ten years say, and divide it by the ten-year treasury and that provides a ratio of how those valuations are relative between those two markets. Historically, we've had a ten year AAA municipal, roughly 86% of the ten-year treasury, because of the tax exemption that we talked about earlier, you would expect that the ten year AAA immunity would be lower than the taxable ten-year treasury. That discount between the ten year AAA immunity and the ten-year treasury reflects the tax advantage nature of the municipal debt and the investor's willingness to take on a lower yield because of the overall tax exemption. And, based upon their marginal tax rate, it is important to realize that municipalities are not necessarily for everyone. They tend to be attractive investments for those in higher tax brackets. Say 25 – 37% range historically has been a very attractive part of the investor universe from municipal bonds.

Henry Dormitzer: I get it, I didn't mean to interrupt you, but just light dawns. If I can buy immunity and get 85% of the income that I would get buying as taxable, that's a 15% less interest than I am getting. That makes sense if I pay 15% or more of my income as taxes. But if I pay less than 15% of my income as taxes, then I would rather buy a taxable bond.

Anson Clough: In its truer sense, yes Henry, that's the analysis.

Henry Dormitzer: We are going to introduce some complication of that in our coming discussion about what happens in the marketplace in reality, but let's put a bookmark in that part so we can come to that later. Maybe you can talk to us then about who buys municipal bonds because probably institutions that don't pay taxes don't want to buy tax-free bonds. So, who does?

Anson Clough: Exactly, municipal bonds are good investments for individuals that are paying taxes, they are good investments for institutional buyers like banks and insurance companies that are also tax-paying entities, but in pensions and foundations, etc. would not be investing in the municipal bond universe on the tax exempt basis. The lying share of your investors in municipal bonds are individual investors, whether they are doing that directly through separately managed accounts, or if they are doing it indirectly through municipal funds. Municipal funds tend to be a very large part of the municipal universe.

Henry Dormitzer: I guess some municipal funds are a big part of the municipal buying universe because a lot of private investors buy mutual funds. I think banks sometimes buy and maybe insurance companies sometimes buy. Why do they buy municipal bonds?

Anson Clough: They would buy it as a risk diversifying asset and they also have the ability to write off the tax exempt income that they are receiving. So they are in a position as a taxable entity that they can benefit up to a specific amount from that municipal bond income and its tax exempt nature.

Henry Dormitzer: Good, that was a wholesome discussion of the basic concepts around municipal bonds. Who buys them, who sells them, how money is pledged, how they are not the same as corporations, and how we talk about ratios as a way thinking about the relative value to bonds that you pay taxes on. When we talked about ratios, I mentioned that we would be coming back to talk about times that can get distributed in ways that we don't expect. That is going to be a topic of our next podcast which is how did the COVID crisis really disrupt the bond market in general and the municipal bond market in specific and create some challenging trading conditions and some interesting credit considerations. So, tune in next time because that is going to be our discussion then.

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Nate and Anson, thank you very much for talking to us about municipal bonds, I love the topic and maybe we get to do it some more.

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