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Tax-Free Travails

Performance of municipal bond market continues to impress, confound

By Jim Reber

For all of you community bankers who have been hoping that your investments hold their value through the expected rate-hike-addled 2016, we've got some good news for you. Also some not so good news. But then again, this is the bond market we're talking about.

I'm a person who can understand a simple table better than some byzantine narrative. Let's take score about the condition of a typical community bank investment portfolio:

Leader or laggard?

As banks have gradually improved their bottom lines this decade, happily the need to avoid tax liability has increased. The use of tax-free municipal bonds by community banks has grown impressively, and they now represent more than one-fourth of all portfolios.

Bond analysts and broker-dealers have continued to recommend them, and their performance has been good. The average outstanding muni is more than 4 percent above water.

This brings us to the paradox of the month: Even though absolute yield spreads are attractive relative to taxable securities, they have collapsed in the last 18 months. Near-term prospects for those investors hunting for value look dicey.

the maximum size of a bank-qualified issue was temporarily raised from \$10 million to \$30 million. Many of these new issues are being gobbled up by non-depositories with little regard to relative value. Hence, the pressure on yield spreads.

Be wise and realistic

So as you and your fellow investment managers fight over the dwindling supply of high-quality munis, a few suggestions can be employed that may make you glad later. These are not new, but are practical and conservative, which are qualities that resonate with community bankers.

The first is to be disciplined about the coupon of the munis that you purchase. The higher the coupon, the lower the duration and price volatility. Paying high premiums on tax-free securities is usually worth it in the long run; the corollary is to be wary of buying munis at a price below par.

ICBA VOICE

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» **Yield:** Not good. Average tax-equivalent yield is 2.50 percent.

» **Market value:** Pretty good. Average unrealized book gain is about 1.00 percent.

» **Length:** Very good. Average base case effective duration is only 2.9 years.

» **Yield spreads:** Pathetic. And headed for worse.

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Something's happening

At least an undercurrent of logic, and economics, is going on that explains this phenomenon of dramatically shrinking spreads. I've already mentioned that demand is on the upswing. Add to that the dynamics of a supply crunch, in addition to the (so far) absence of a headline bankruptcy, and the seeds for a rally have germinated.

In spite of popular perception that states and local governments are awash in debt, the reality is that there are fewer bank-qualified municipal bonds out there right now than there were 10 years ago. Large percentages of new issues are simply refinancings of outstanding debt, much of which was issued in 2009 and 2010 when



Second, if your community bank is exposed to rising rates, you can convert your munis into adjustable-rate securities using interest-rate products. These "Do-It-Yourself Floaters" have become increasingly attractive as the curve has flattened over the

Takeaway:

The prices of high-quality municipal bonds have risen, concerning investors.


DIY Floater Literature

Vining Sparks, the exclusive broker of ICBA Securities, has recently published a Strategic Insight, "The DIY Floater to Maturity." The publication explains the mechanics and benefits of insulating a municipal portfolio against rising rates.

To receive a copy, contact your Vining Sparks sales rep.

last six months.

Finally, with the supply-demand issues discussed above, and community banks' still-low cost of funds, it may be tempting to purchase General Market (that is, nonbank qualified) munis. It has long been my view that such a strategy has embedded risk from both market price and tax-equivalent yield standpoints. At a minimum, a defined exit strategy should be in place at the time of acquisition.

Good luck with your muni hunting. Be careful out there. 

ICBA Investment School

The 2016 ICBA Bond Academy will be held Oct. 24-25 at the Embassy Suites in Memphis, Tenn. This program will train community bankers on the basics of investment management, and attendees are eligible to earn up to 12 hours of CPE credit.

For more information, contact your Vining Sparks sales rep or visit www.icbasecurities.com.