MEMO: THE IMPORTANCE OF 5% COUPONS IN RISING RATE ENVIRONMENTS - PART DEUX

By Brent Sheehan, Fall 2021

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Background

We recently published a White Paper on the importance of coupon structure in bond selection. We examined how 3%, 4% and 5% coupon bonds reacted under different stress scenarios. The White Paper made the case that 5% coupon bonds, our preferred structure, clearly outperformed under a variety of shock scenarios.

With the recent aggressive move in US Treasury rates, we felt it was appropriate to examine actual bonds and how they reacted from a price/return standpoint. To demonstrate this point, we wanted to find two bonds (CUSIPS) from the same issuer with a comparable or similar maturity profile. This would largely eliminate any "spread" differences that might arise between different issuers and credits. Ideally, the CUSIPS would be new issues as there would be no up-front mark-up to distort the analysis.

Once we identified an issuer and a deal, to do a proper analysis we needed a 5% Premium bond, our preferred structure, and a bond which retail would normally own, typically a Par bond.

Bond Selection

The period selected for analysis was this past month. During the period from September 21, 2021, to October 22, 2021, the 30-year US Treasury rose 26 basis points from 1.81% to 2.07%.

With respect to bond identification, on September 21st, 2021, the State of Massachusetts (AA, Aa1) came to the market to issue debt through the competitive new issue process. Two different major Wall Street dealers bid on the debt using two completely different bond structures, one Par (Bank of America) and one Premium (Jefferies). While it is too early to know the actual holders of the bonds, it is fair to assume the Par structure was designed to appeal to retail investors. In Appendix A, we have Bloomberg snapshots of the two bonds and in Appendix B, a primer on the difference between a competitive deal and a negotiated deal. (**CHART TO THE RIGHT IS A SUMMARY OF THE TWO DEALS.**)

	RETAIL BOND	INSTITUTIONAL BOND
Issuer	Commonwealth of Mass	Commonwealth of Mass
Type	General Obligation	General Obligation
Sale Date	9/21/21	9/21/21
Maturity	9/1/47	9/1/48
Coupon	2.38%	5.00%
New Issue Price	100.218	130.177
Structure	Par	Premium
Rating SP	AA	AA
Rating Moody's	Aa1	Aa1
CUSIP	57582RR73	57582RR81
Underwriter	Bank of America	Jefferies
Deal Type	Competitive	Competitive

One Month Shock Analysis – 5% Premium Bond versus 2.375% Par Bond

In the table below we highlight the performance of both these Massachusetts bonds using their end of day pricing on the specified dates.

PAR - RETAIL STRUCTURE
MA GO 2.375% DUE 2047

		PRICE	YIELD
9/21/21	New Issue Price	$100.218	2.35%
10/22/21	Eval Price	$95.498	2.51%
		-4.9%	0.16%

PREMIUM - INSTITUTIONAL STRUCTURE
MA GO 5.00% DUE 2045

		PRICE	YIELD
9/21/21	New Issue Price	$130.177	1.68%
10/22/21	Eval Price	$127.161	1.86%
		-2.4%	0.18%

Source - ICE Pricing

The difference in performance is overwhelmingly supportive of our opinion that owning the right structure of bond can have a huge impact on the performance of your portfolio. Often, we know that bonds are sold to retail investors with an emphasis on "not paying above par" for a bond. If the client is sold a municipal bond with the choice of a purchase price of $100.00 vs. $115.00 or in the example in the table above - $100.218 vs. $130.177 usually the easier sale to a retail client is the one where they pay $100.218. When actively managing municipal portfolios, we want structures that will perform the best for our clients in different rate environments. We also look for the most liquid structures so we can make tactical trades in a timely fashion. In the above example, the Premium 5% coupon structure significantly outperformed the Par retail structure. We recognize that this is two bonds and the performance may be different among different bonds during different date ranges. That being said, the central thesis remains valid that 5% coupon bonds are more defensive in rising rates.

Conclusion

The municipal bond market is complex. Bond selection matters a lot. To this end, understanding what bonds to buy and not to buy can have a meaningful impact on one's portfolio. As outlined above, coupon selection is an important consideration that needs attention.

As part of our White Glove service, we can provide a shock analysis for your third-party managed portfolio. Please reach out to us should you have any questions.

APPENDIX A

Example #1 Par Bond

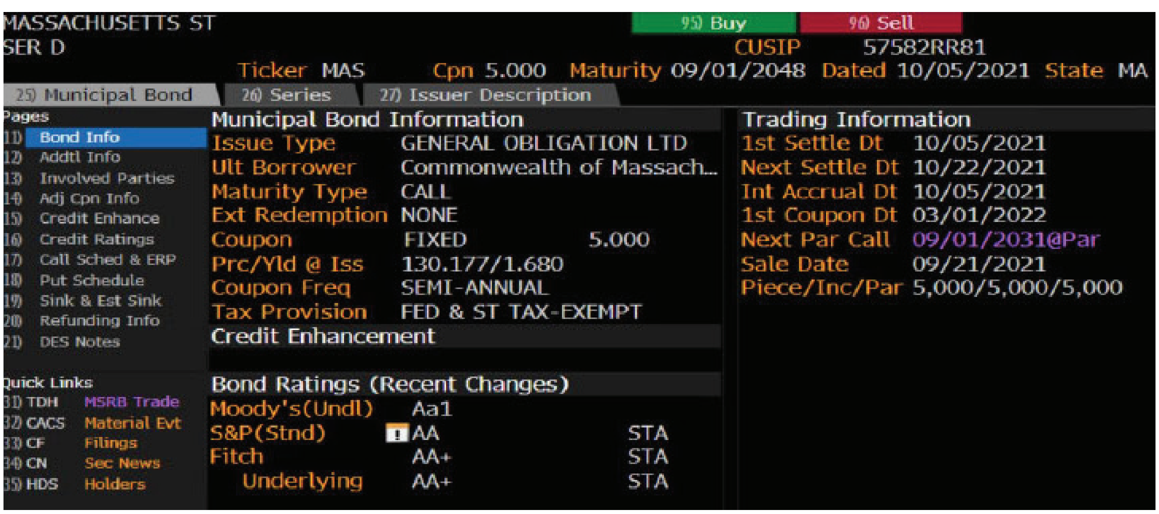
Massachusetts State General Obligation 2.375% coupon maturing 9/01/2047

NEW ISSUE PRICE OF $100.218 / 2.35% YIELD

Example #2 Premium Bond

Massachusetts State General Obligation 5.00% coupon maturing 9/01/2048

NEW ISSUE PRICE OF $130.177 / 1.68% YIELD



APPENDIX B

Competitive versus Negotiated Bond Deals

A competitive sale and a negotiated sale are the two methods by which an underwriter may purchase municipal bonds from an issuer for reoffering to the public. In a competitive sale, bonds are advertised for sale. The advertisement, by way of a notice of sale, includes both the terms of the sale and the terms of the bond issue. Any broker dealer or dealer bank may bid on the bonds at the designated date and time. The bonds are awarded to the bidder offering the lowest interest cost.

In a negotiated sale, an underwriter is selected to purchase the bonds. The underwriter, in turn, sells the bonds to its investor customers. The terms of the bonds are tailored to meet the demands of the underwriter's investor clients, as well as the needs of the issuer.

Negotiated sales also involve a process known as a presale in which underwriters seek customer indications of interest in the issue before establishing final bond pricing. The method of sale is known as a negotiated sale because the terms of the bonds and the terms of the sale are negotiated by the issuer and the bond purchaser. Negotiation suggests a two-party process. To be an effective negotiation, the issuer should have sufficient knowledge of debt financing to take an active role in establishing the terms of the issue and sale. If the issuer does not have the knowledge or experience to effectively negotiate bond terms, an independent financial advisor can serve as a third-party negotiator.