

Redstone Advisors



Municipal Bonds: A "Unique Market"

Common Myths about the Muni Market

Myth #1:

When I buy or sell bonds, there are no transaction costs

Answer:

Be careful you don't get "stepped on"

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The municipal bond market is one of the largest and most unique securities market in the world. Aside from their most well known peculiarity, the tax-exempt status of their interest income, municipal bonds are unique among fixed-income asset classes in another important aspect. Unlike other fixed-income markets, *individuals*, not institutions, make up the largest investor base for municipal bonds. As a result, the municipal bond market presents unique **challenges** as well as **opportunities** for those who invest in them.

To begin with, the municipal bond market is not a **homogenous market**. Instead, the **\$2.8 trillion** municipal bond market is comprised of over **2 million** dissimilar bond issues of all shapes and sizes, issued by over **50,000** separate state and local entities, each carrying its own unique **credit risk profile**. Contrast this with the U.S. Treasury market, a market dominated by institutional investors. At approximately **\$7.6 trillion**, the Treasury market is nearly **three times the size** of municipals in market value, but the Treasury market consists of a **single issuer** and less than **300 separate bond issues**. And because all Treasury securities carry the “**full faith and credit**” guarantee of the U.S. government, there is only one credit profile and it is risk-free. Consequently, the only difference between one Treasury bond and another is the coupon and maturity.

This is not the case with municipal bonds, where **no two bonds** are alike. From general obligation bonds to dedicated revenue bonds, rated to non-rated, insured to non-insured, bank qualified to AMT eligible, callable, puttable, pre-refunded and “sinking”, there is simply no such thing as a “**generic**” municipal bond. And it is because each issue is “unique” that municipal bonds are traded in the **over-the-counter** (OTC) market rather than on an organized exchange.

In an organized exchange, such as the New York Stock Exchange, all traded securities are “**listed**” so that many buyers and sellers can arrive at a single price based on an **auction process** of competitive “*bid*” and “*ask*” levels. The presence of **many** buyers and sellers competing for securities in a central location on the basis of a highly visible price, makes for a very **liquid** and **efficient** market. In stark contrast, buying and selling in the OTC market occurs via a network of “*middlemen*”, called **dealers**, who carry **limited inventories** of securities that *they* price and then try and sell to investors. Trading takes place directly between **two-parties**, with prices determined on a **negotiated basis**. Because there is no **central exchange** for municipal securities, a **single visible price** does not exist for individual securities. And because the majority of outstanding municipal bonds are owned by “*buy and hold*” individual investors, most municipal bonds do not trade for

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long periods of time, greatly reducing liquidity for most issues. This type of market **breeds inefficiencies—inefficiencies** that are reflected in **security prices**. However, for managers who understand the nuances of both the market and the securities, these inefficiencies represent **opportunities** to add value to municipal portfolios.

One of the ways in which Redstone is able to add value for its clients in a municipal bond portfolio, is by identifying and avoiding payment of the excessive **“markup”** that is routinely present in dealer-offered prices of municipal bonds. Markup refers to the difference between the **dealers cost** and the **offered price** of the bond and as such, it represents the dealers **“profit”** on the trade. Markups of **1 to 3 percent** on municipal bonds are common. At Redstone, we actively manage the dealer markup, striving to reduce the markup paid to less than **0.50 percent** per trade.

Additionally, at Redstone we avoid purchasing bonds that have been **“stepped on”** too many times. In the dealer community, the process of marking up a bond is commonly referred to as **“stepping on”** a bond. As such, **each time** a bond is marked up and traded, the bond is said to have been **“stepped on”**. Because liquidity in the municipal market relies on a frag **fragmented network** of regional dealers, it is not uncommon for a given bond to be “stepped

on” **multiple times** as it is passed from **dealer-to-dealer**, before it is finally sold to a prospective buyer(s) looking for a security with those particular characteristics. Over the past 23 years, we have developed relationships with a number of key regional broker/dealers who bid aggressively on new issues coming to market and maintain an extensive inventory of secondary market bonds. As such, we have access to their inventory and we will often **“see the bonds”** before the new issues come to market, or when secondary market bonds sold out an investors portfolio are initially **“offered for sale”**. This **“early look”** affords us the opportunity to purchase bonds for our clients before they get **“stepped on”** too many times in multiple **interdealer trades**.

The graphic on the following page illustrates this by using as an example, an **actual trade** executed by Redstone on behalf of one of our clients. The graphic is an actual screen shot from the **Investing in Bonds** web site, found at www.investinginbonds.com, which reports information on municipal bond trades by dealers and brokers as per rule G-14 established by the Municipal Securities Rulemaking Board. *(Please note, that in addition to the graph, text details of the trade information contained in the graph, though not included here due to space constraints, are also available at the web site)*

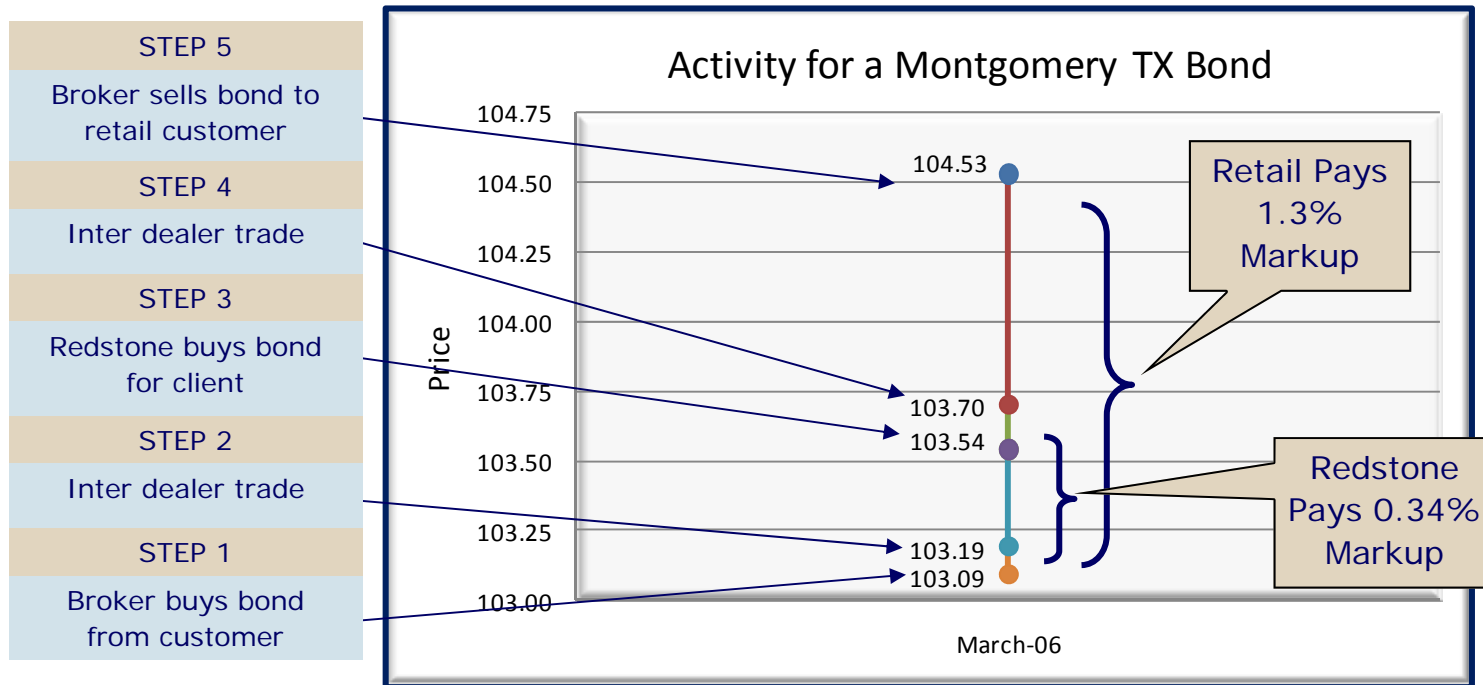
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Referring to the illustration and the trade details, we can see that on March 13, 2006, \$500,000 of the Montgomery County Texas Municipal District Number 67 4.75% bond due September 1, 2014, CUSIP 613924ES4, was sold by a customer to a broker at a dollar price of \$103.090. This is notated on the illustration as **STEP 1**. This \$500,000 block was then sold to another dealer in an **interdealer trade**, at a dollar price of \$103.190. This is notated on the illustration as **STEP 2**. *(Please note that it is at this point that the bond is “offered for sale” and as such, \$103.190 becomes the benchmark price against which all subsequent markups will be measured)* On March 14, 2006, Redstone purchased \$100,000 of this bond for our client at a dollar price of \$103.539, representing a markup of **0.34 percent**. This is notated on the illustration as **STEP 3**. *(Please note, another \$250,000 of the bond was sold on March 14 to a different customer at the same price of \$103.539)* The remaining \$150,000 block of the security then changed hands two more times on March 14 in separate **interdealer trades**, first at a dollar price of \$103.643 and then at a dollar price of \$103.703. This is notated on the illustration as **STEP 4**. Finally, the remaining \$150,000 block of the security was sold by a dealer to a customer on March 14 at a dollar price of \$104.531, representing a markup of **1.30 percent** from the time the bond was “offered” on the market. This is notated on the illustration as **STEP 5**.

In all, the bond was “stepped on” **five times** with a **total markup**, or profit margin of **1.3 percent** “put in” the bond before the final sale to an unwary customer. *(Please note that the purchase by Redstone and the sale to the final customer, occurred on the same day, **March 14**, illustrating that the difference in the price paid was due to a lack of awareness regarding the **fair value** of the bond, not a change in the general level of interest rates)* On a purchase of \$100,000 par value of the bond, the difference between the price paid by Redstone and the price paid by the final customer, was approximately 1 percent or \$1,000.

As we mentioned earlier, by virtue of its inefficiencies, the unique challenges of the municipal market offers unique opportunities to managers who understand the nuances of both the securities and the market. Unfortunately, this is something that can really only come from experience and time in the municipal market. With over 20 years of hands-on experience in the municipal market, this is an area where we believe that we can consistently add value to client portfolios.

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