

# Pre-refunded Municipals

Taking advantage of the jump in price



by CJ  
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Consider the following scenario: You are the treasurer for a small town with \$10 million in debt, funded by a municipal bond issue. The issue costs your town 5.1 percent annual interest and matures 15 years from now in the year 2018. The issue is callable in five years, in 2008.

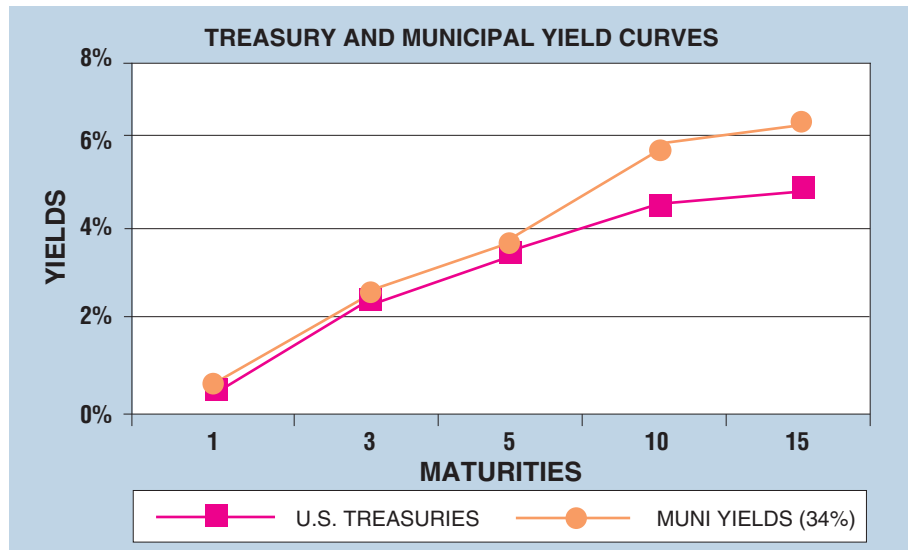
As you work on next year's budget, you realize that the 5.1 percent interest is much higher than the 4.3 percent that the *Wall Street Journal* says is the current rate for 15-year debt like yours. You could substantially reduce expenses if you could refinance the town's debt at today's lower rates.

Then you have a brainstorm! What if you had a new bond issue and borrowed money at today's 15-year rate of 4.3 percent, invest the new money in a five-year Treasury and then, at your bond's five-year call date, use the maturing Treasury proceeds to call your old 5.1 percent bonds. In five years, your debt service will drop from 5.1 percent to 4.3 percent, and you would have done it with no risk to your principal.

You call your friendly investment banker and "do the deal." You have now pre-refunded the town's long-term debt.

## Investors' Options

The investor originally owned a 15-year muni with a 5.1 percent coupon and a five-year call date. She now holds a *five-year* muni with a 5.1 percent coupon. And the price



has jumped almost five points—from 105.91 to 110.73. The jump in price reflects the fact that there is no longer any chance that the bond payout will extend beyond five years.

The investor now has a choice. Should she continue to hold the five-year, 5.1 percent bond, or sell at the high premium and reinvest in something else?

**Option 1:** The investor can hold the original security and earn 5.1 percent for the next five years. When the security is called, the investor can reinvest the proceeds at whatever the current rates are at that time.

**Option 2:** The investor can sell the five-year muni at 110.73, the current market price for five-year munis with 5.1 percent coupons. The proceeds from the sale can be reinvested at 4.3 percent in a 15-year muni to match the maturity of the original investment.

**When an investment's spread to the Treasury curve widens, its relative price becomes cheaper.**

**The Analysis:** One way to think about an investment is to think of its value relative to a comparable Treasury. And, to think about relative value, you can consider relative spreads to the Treasury curve; that is, when an investment's spread to the Treasury curve widens, the investment's relative price becomes cheaper.

The graph above shows that tax-free spreads to the Treasury curve usually widen significantly as maturities lengthen. This means that the relative prices of tax-frees get cheaper as maturities lengthen. This phenomenon supports the argument

for selling short tax-frees (since they have relatively low yields and high prices when compared with the Treasury curve) and replacing them with longer tax-frees (since they have relatively high yields and low prices when compared with the Treasury curve).

Assume that the original investment was \$100,000. Choosing

Option 1 (holding the 5.1 percent bond to maturity), allows the investor to make \$5,100 a year for five years for a total of \$25,500. She can then reinvest the maturing bond proceeds at whatever the current rate is when the five-year matures.

Alternatively, the investor can sell the bond for \$110,730, book an after-tax profit of \$7,082 (\$10,730

minus 34 percent tax) and earn \$4,300 a year for five years for a total of \$28,582 plus any additional interest earned on the initial profit of \$7,082. The bond would then have an additional 10 years at a 4.3 percent yield before final maturity.

Then there is the question of when the profits are most needed. If the bank's spreads are being squeezed now, it may make sense to take profits now to improve this year's earnings and, if the bank is asset sensitive, to let rising rates improve the bank's earnings and compensate for the lower earnings from the tax-free swap.

Another question, of course, is whether or not rates will be so high in five years, that it might make sense to forego the current sales profits in favor of having the principal in five years to reinvest at the higher rates.

If the expectation is that rates may be much higher in five years, the investor can still take the \$7,082 profit by selling the pre-refunded muni, and then reinvest in five-year securities that have greater five-year short-term yields; such as mortgage-backed securities or corporates. **IB**

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### For More Information

ICBA members are invited to call ICBA Securities at (800) 422-6442 for:

- Identification of pre-refunded issues;
- Identification of potential pre-refunded issues;
- Swap analyses of pre-refunded issues;
- Identification of reinvestment alternatives; and
- *Independent Banker* article explaining takeout yield.