



Michael D. Axel, CFA

Buyer Beware

How do you evaluate a bond's price? It's easy to overpay. Bond sales people certainly won't stop you. Individual investors frequently end up overpaying. For tax-exempt bonds there is an entire website, www.municipalbonds.com, devoted to listing outrageous markups in recent bond trading. Typically the victims are retail investors who buy and sell odd lots of less than \$1 million.

Buyers need benchmarks for determining whether a bond is cheap, expensive, or just average. There is no single yardstick. For certain types of bonds, one particular yardstick may work better than others. Knowing how and when to use a particular yardstick is key to the way AMI Investment Management selects bonds for our clients' portfolios. For tax-exempt bonds, AMI utilizes six types of benchmarks:

- Muni-to-Treasury ratios
- Spreads to various AAA yield curves
- Newly priced deals in the primary market
- Posts on actual trades
- Where the bond has traded in the past
- Prices we receive when we sell bonds.

Muni-to-Treasury Ratios

In recent years the average ratio for muni-to-Treasury yields has been approximately 80%. But the ratio varies significantly from week to week and along the maturity spectrum. Over the past year, by looking at many different bond offerings, AMI frequently has been able to purchase high-quality bonds at ratios well above the 80% average.

Yield Curves

High-quality bonds are priced on the basis of spread to the risk-free yield curve. However, finding the AAA yield curve for tax-exempt bonds can be a challenge for individual investors. We use our Bloomberg Financial Markets terminal for updated yield curve information.

New Deals

Every business day, underwriters in the primary bond market sell new bond deals. Certain deals can be utilized by participants in the secondary market as clues to where the true yield curve is situated. But many deals will not work because of peculiarities specific to the issue. Generally a larger AAA-rated transaction, in excess of \$100,000,000 without any unusual features such as an extraordinary call option or forward settlement, can be used. But bonds from all 50 states do not trade alike, so to some extent, yield curves are state-specific. For example, in 2003, yields on Oregon and Maryland bonds were typically lower than the similar bonds from other states because of high state income tax rates and constricted supplies of bonds.

Trade Posts

Every day there are actual trades in the bond market that point to the market's direction and what particular types of bonds are worth that day. Market participants can obtain trade posts via next-day reports to the MSRB (Municipal Securities Rulemaking Board). Broker/dealers disseminate trade posts in various newsletters and emails. Institutional investors can give and receive rough posts from sellers when bonds are listed for sale in the bid market. Trade posts are the appropriate benchmark for bonds that are more difficult to value, perhaps because of credit or structural flaws.

Where the Bond Has Traded in the Past

As with trade posts, this benchmark typically is used for bonds that are somewhat impaired, less than clean AAA-rated securities. If the bond, or another bond from the same issuer, has traded in the past at a spread of 125 basis points, and no material changes have occurred, then most likely it will continue to trade with a similar spread. However, credit spreads widen and narrow over time, so this method must be handled gingerly.

Bids Received When We Sell Bonds

Sometimes we are a seller and invite the market to bid on a list of our bonds. We sell to the highest bidder. This is the ultimate test of what a bond is really worth.

The Result

More than 10 years of daily participation in the bond market has enabled AMI to assemble a broad collection of bonds and issuers whose trading value we know intimately. We feel that we have a sound understanding of how various bonds typically trade. AMI adds value to the management of fixed income portfolios in two ways: 1) Purchasing and selling bonds at attractive prices based on our years of daily experience in the bond market; and 2) Managing the interest rate risk of our clients' portfolios by actively managing the duration (Duration is a measure of interest rate sensitivity that we will discuss in detail in a future issue) of each portfolio.

Sincerely,

Michael D. Axel, CFA

How Bad Can It Get?**Real Life Example of Bond Market Pricing Discrepancies**

On April 30, 2003 the following bond was purchased by a broker from a retail customer at par:

Flatonia Texas Independent School District

AAA Maturity: 8/15/2007 Coupon 4.25%

Purchased Par Volume: 75,000 Price: 100.00 Yield: 4.25%

The same broker turned around and sold the bond that day at 108.41, an outrageous markup!

Sold Par Volume: 75,000 Price: 108.41 Yield: 2.15%

What was the bond actually worth?

Based on the attributes of the bond, AMI would have valued it at approximately 105.50, to yield 2.45%.

This broker exploited both the buyer and the seller.

Source: Bloomberg