Municipal Market Comments

Ascent Investment Partners

January 14, 2013

from Montage Investments

Columbus Highlights Risk in BABs

In the coming weeks, Congress will negotiate the pieces of the "Fiscal Cliff" that were put off in the year-end tax agreement: an increase in the Federal debt ceiling and the mandatory spending cuts ("sequestration") required by the Budget Control Act of 2011. As we have discussed in the past, one of the potential impacts of the automatic spending cuts would be an estimated 7.6% cut in Federal payments for interest subsidies to issuers of taxable Build America Bonds (BABs) and other taxable municipal bond structures created by the American Recovery and Reinvestment Act of 2009 (ARRA). Most BABs included extraordinary optional call features allowing issuers to call bonds if the Federal government ever reduced or eliminated the subsidy payments from the Treasury to the issuer. If the Federal government reduces these payments to BAB issuers as a result of sequestration, it could trigger the optional call features.

BABs have become a very popular alternative to corporate bonds for investors seeking high-quality taxable fixed income investments. They were only issued in 2009 and 2010, and since then market yield levels have dropped significantly. As a result, most BABs now trade at substantial premiums. The risk to investors comes from the potential that the BABs purchased at premiums could be called away at prices below cost basis. The BABs at greatest risk contain calls at par.

Though most issuers sold their BABs with corporate-like call features, some included calls that were traditional municipal bond calls at par. Columbus, Ohio (rated Aaa/AAA/AAA) was one of these issuers and provides a good illustration of the risks faced by BABs investors. In 2009 and 2010, Columbus issued $475 million of BABs and Recovery Zone Economic Development bonds (another ARRA taxable municipal structure with a federal interest subsidy) in eight separate issues. Each of the issues contains call language allowing the City to call the bonds at par if the Federal interest subsidies are reduced, or even if the Treasury announces the "intent to reduce" the payments.

In late December, Columbus publicly stated its intention to exercise the optional par call in its BABs issues if automatic Federal spending cuts triggered a reduction in interest subsidy payments. Because the bonds were issued with coupons ranging from 1.75% (due June 1, 2013) to as high as 6.10% (due in 2031), their market prices have increased substantially since issuance. In today's rate environment, the City could issue tax-exempt bonds at approximate yields ranging from 0.20% to 2.30% in the same maturity range and use the proceeds to redeem its BABs.

Because of the strong rally in the bond markets since 2010, the market prices of BABs soared. According to trade data reported to the Municipal Securities Rulemaking Board, a representative Columbus BAB maturing in 2020 (4.74% due 7/1/20, CUSIP# 199491G39) saw its average trade price rise from $100 at issuance in November 2009 to over $118 through most of 2012. However, as the risks of sequester cuts became more apparent in late 2012, the average trade price of this bond declined from $118.32 in early September to $111.625 in early November. This bond has not traded since the City made its comments in December. In comparison, BABs with comparable credit quality and maturities, but without the par call risk, have seen virtually no change in market levels over the same period.

Ascent began reviewing clients' BABs holdings in the second half of 2012 to evaluate the risks of losses from sequester-triggered issuer calls. After evaluating the relative call risk of all of the BABs and similar bonds held by our clients, we sold all of the highest-risk BABs before we saw any significant downturn in market prices, including all of our holdings of Columbus BABs. While it is possible there may be no cuts to BABs subsidy payments and calls might not be triggered, our view is that conservative fixed-income management best serves investors by seeking competitive returns while limiting market and credit risk, including clients' exposure to substantial losses from uncontrollable call risk.

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