MSRB

Understanding New Issue, High-Yield Municipal Bonds

Overview

High-yield municipal bonds[1] are issued by state or local governments to finance projects with uncertain revenue streams that are typically non-rated or rated below investment grade by credit rating agencies.[2] The higher yields provide investors with larger returns on their investments to compensate them for the increased credit risk associated with the projects and the lower credit ratings. High-yield bonds also can provide greater overall portfolio diversification. High-yield municipal bonds may be issued to finance projects with a high risk of delayed completion or other unique risks, or to address situations such as bankruptcies or defaults. High-yield municipal bonds often include security features such as liens on land or tax liens on the project and/or security interest in the revenue stream, giving investors more potential remedies in the event of distress or default.

High-yield bonds compensate investors for increased credit risk.

Considerations for Investors

Investors considering investing in a new issue, high-yield municipal bond should keep the following factors in mind:

- Security Features
- Suitability
- Liquidity
- Volatility

Security Features

Along with higher yields, which help compensate investors for the added risk, investors should consider the economics of the project being funded and understand the type of security pledge. Security pledges may include:

- A revenue pledge, which provides a security interest in the revenues generated by the project;
- A limited tax revenue pledge, where only those tax revenues pledged to debt service support the bonds;
- An incremental tax pledge, where only the new tax revenues generated by the project support debt service;

1 High-yield bonds discussed here are not those that bear high yields because of secondary market movements. In those cases, high yields may be the result of adjustments to yields to reflect current market levels.

2 Investors should not purchase any municipal bond, including unrated municipal bonds or municipal bonds with a low credit rating, without fully assessing the risks of the municipal bonds. Investors should understand that credit ratings are not a seal of approval and should be only one of many factors used in evaluating a municipal bond investment. Also, because ratings can change at any time, investors should not assume the rating shown on the official statement when the bond was first issued remains in effect if it is purchased at a later date. Rating levels "below investment grade" typically indicate that the bond has a relatively higher risk of default and not meeting current or long-term financial commitments, or has sensitivity to adverse economic conditions.

- A first mortgage lien on property or other assets; or
- Other forms of security interests in the real estate or project.
- In addition to financing projects, high-yield municipal bonds may finance bankruptcies or indenture defaults. High-yield municipal bonds issued as a financing solution to fund all or part of an issuer's outstanding obligations causing the financial distress present a different set of risks to investors. The bonds may require several tranches of senior and subordinate debt that offer different rights to priority of payment in the event of nonpayment by the issuer. An issuer may structure its financing in this manner in order to raise as much money as possible by attracting a broader market of investors with varying tolerances for risk. These types of structures increase the risk to investors' recovery of principal, particularly if they hold competing rights to priority of payment in the event of default and/or incomplete payment of the debt service.

Investors should understand any credit support provisions and triggering events.

To the extent high-yield municipal bonds are supported by credit enhancement or other payment guarantees, investors should understand the provisions of the credit support and the events that will trigger a call on the credit support, as well as all the circumstances and/or conditions for limiting or not offering the credit support to investors.

Suitability

While new issue, high-yield municipal bonds may provide potentially higher income as well as portfolio diversification, they may not be suitable for all investors. Because high-yield municipal bonds typically involve higher risk, investment in these bonds may be restricted to investors who are able and willing to accept and tolerate that risk. For example, high-yield municipal bonds may be offered in private placements or other limited offerings to institutional investors, including investment funds. Originally-issued high-yield municipal bonds generally present a greater risk of such events as covenant and payment default than do other types of municipal bonds. Evaluating high-yield municipal bonds typically requires understanding issues relating to land or infrastructure development, potential impact on balance sheets and income statements, and related policy issues. Therefore, an investor's risk profile is very important to determining whether high-yield municipal bonds are a suitable investment.

Liquidity

Generally, the market for high-yield municipal bonds is much smaller than for investment grade municipal bonds, so it is much less "liquid" — meaning that trading volumes are lower, and it is relatively more difficult to readily convert the bonds into cash. Consequently, high-yield municipal bonds can have a greater downside when bond prices weaken. Further, "headline risk" can affect liquidity. Events in the news that have nothing to do with actual credit factors may nonetheless have an effect on high-yield bond prices.

Additionally, high-yield municipal bonds are usually issued in higher minimum denominations than typical municipal bond issues, which may limit resale and cause the bonds to be less liquid due to a more restricted market of buyers for whom the bonds would be suitable.

Volatility

While investment grade municipal bonds are more affected by interest rate risk and less affected by credit risk, the opposite is usually true for high-yield municipal bonds. Higher yield means higher risk. As a result, price fluctuations can be much larger in high-yield municipal bonds.

Additionally, the performance of high-yield municipal bonds is driven more by the financial strength of the underlying issuers than by movements in interest rates, making them more sensitive to changes in economic conditions than investment grade issues. As a result, investors may face a longer time horizon to recover from any negative impacts on their bonds from market fluctuations caused by economic events. Higher risk may translate to higher yields, but it does not always mean higher total returns in a given period.

While high-yield municipal bonds can offer an opportunity to purchase investments that will generate higher levels of income and provide greater overall portfolio diversification, investors should carefully evaluate the associated risks before choosing to invest.

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