What to Expect When Selling Municipal Bonds Before Maturity

While investors in municipal bonds often are “buy and hold” investors—that is, they intend to own bonds as long-term investments to be held to maturity—investors may wish or need to sell their bonds prior to their stated maturity. There are risks and costs associated with selling a municipal bond prior to maturity. Investors should understand these risks and costs when considering the purchase and sale of municipal bonds. This document provides an overview of these key considerations.

An understanding of the differences between par value and market value, the factors affecting pricing in the secondary market, the trade execution venues, and the transaction costs associated with selling a municipal bond in the secondary market can assist an investor in making better informed decisions with respect to the purchase and sale of municipal bonds.

Par Value versus Market Value

Bonds have a par value or fixed face value, which may be different from the bond’s market value. The par value is sometimes referred to as the face value of the bond and is the principal amount that the investor will be paid upon maturity of the bond. The market value of a bond, on the other hand, is the price at which investors likely will buy or sell the bond in the secondary market prior to maturity, which may differ from the par value based on a number of factors, described in the following sections.

Pricing Factors in the Secondary Market

A number of factors in the secondary market will influence a bond’s market value. These factors include:

- Interest Rate Risk — the risk posed to the owner of a bond as a result of interest rate fluctuations. When interest rates rise, bond prices tend to fall; conversely, when rates decline, bond prices tend to rise. Accordingly, if interest rates are higher at the time that an investor attempts to sell a municipal bond than they were when the investor initially purchased the bond, the price at which he or she will likely be able to sell the bond would be lower than the price at which the bond was originally purchased by the investor, all other factors being unchanged. Learn more about interest rate risk here.

- Liquidity Risk — the risk that there may not be a significant market for the purchase and sale of the bond. Liquidity refers to the likelihood of finding a willing buyer for a specific bond. The risk of not finding a buyer,
or the liquidity risk, is dependent on a number of factors. For example, liquidity risk may generally be greater for lower-rated bonds, bonds that were part of a small issue, bonds that have recently had their credit ratings downgraded or bonds sold by an infrequent issuer, among other factors. More liquid bonds are typically those for which there is a large trading volume and a large number of dealers that routinely buy and sell such bonds. In general, greater liquidity enhances the market value of the bond. The converse is also true. The more illiquid a bond, the more likely the bond will have a lower price in the secondary market and there may be fewer bids for the bonds. Generally, the fewer bids, the greater the price disparity between the bids and current market levels.

- **Legislative Risk** — the risk that a change in the tax code could affect the value of taxable or tax-exempt interest income. For example, the increased likelihood of a significant change in the tax exemption features of municipal bonds, which was not present at the time the investor originally purchased a tax-exempt bond, may cause a downward pressure on the price of the bond in the secondary market.

- **Default Risk** — the risk that a bond issuer will be unable to make interest or principal payments as they become due. Significant events that transpired after an investor purchased a bond, such as ratings downgrades or other material events which may reflect an increased likelihood of default on the bond, may cause potential investors to value the bond at a lower value than the price paid by the investor.

While risks for potential losses can arise as a result of changed conditions since an investor purchased a bond, countervailing changes affecting one or more of these factors can also result in gains for the investor.
Consequences of Secondary Market Sales

When an investor sells a municipal bond, there are potential financial consequences that should be taken into consideration. These include:

- **Potential Loss on Principal** — The market value of a municipal bond is governed by a number of factors, including those described above. If these factors are significantly different from those at the time that the selling investor initially purchased the municipal bond, the investor may receive less than the par value on the bond if he or she chooses to sell the bond prior to maturity in a secondary market sale. In contrast, unless the issuer defaults in the payment of principal, an investor that holds the bond to maturity rather than selling it in the secondary market would receive the full par amount of the bond at maturity regardless of any changes in market value. Of course, as noted above, countervailing changes affecting one or more of these factors can also result in gains for the investor.

- **Foregone Interest** — Investors who hold municipal bonds to maturity typically derive their income on the bond from the interest payments made on the bond, either throughout the life of the bond or upon maturity. However, investors who sell their bonds prior to maturity will only receive the interest due on the bond until the date of the sale. They will lose all rights to the interest that would have accrued between the date of the sale and the bond’s maturity date.

- **Reinvestment Risk** — Investors seeking to reinvest the proceeds received from the sale of a municipal bond in another investment vehicle may or may not be able to earn a comparable or better yield in the new investment. Investors should carefully weigh the risks and potential rewards of any bond that they are considering selling against the potential investment, including the risks (described above) and transaction costs (described below) associated with the sale of a municipal bond they currently hold.

Execution Venues

Municipal bonds in the secondary market are traded over-the-counter. A dealer, who will generally buy and sell a municipal securities investor's bonds, may do so using any number of venues, including electronic trading platforms and broker's brokers. A particular execution venue may result in a more favorable price to the investor. Learn more about working with a broker.

Transaction Costs

There are two significant costs that may be associated with the sale of a municipal bond: mark-downs and tax implications.

- **Mark-downs** — A mark-down is the primary means by which a dealer is compensated in connection with its customer's sale of a bond, rather than a commission that the investor would usually pay when buying and selling stock. The mark-down is an amount by which the dealer reduces the sales price of the bond from its prevailing market value (that is, the price at which it likely could resell the bond to another dealer under current market
conditions) in order to compensate the dealer and to cover associated costs of the transaction. While the amount of any mark-down may differ depending on the dealer, MSRB rules require that the mark-down, and the overall price at which the bond is sold, is fair and reasonable. Unlike commissions, mark-downs are included in the overall transaction price. Sometimes, mark-downs are also separately disclosed on an investor's trade confirmation if the dealer sold that bond to a third party in a same-day transaction. Investors should talk to their dealers — in advance of a sale — about the price at which the dealer might sell the bond, understanding that the par value and the market value of the bond may not be the same at the time of a contemplated sale. Learn more about the obligations of brokers toward their customers.

- **Tax Implications** — Investors should discuss with their tax professionals any potential tax implications associated with selling a municipal bond prior to its maturity. This could include a discussion about capital gains taxes if the investor expects that the bond may be sold at a profit, since any profit gained on the sale would generally be subject to a capital gains tax even though the interest received on the bond is tax-exempt. For example, if a bond was initially purchased for $950 but sold in the secondary market for $1,000, the selling investor would typically be responsible for paying tax on the $50 gain on the bond. Also, if the bond was purchased at a deep discount, investors may also wish to discuss with their tax professionals whether there are any ordinary income issues to consider.

Market conditions may change between the time that a municipal bond investor purchases a bond and decides to sell it in the secondary market. These conditions along with other factors, such as the transaction costs and risks associated with a sale in the secondary market will likely impact the price at which an investor may sell the bond in an over-the-counter transaction. Investors who are considering selling a municipal bond prior to its maturity should discuss these considerations with their financial professionals, understanding that MSRB rules require that the price at which a customer’s broker or dealer buys or sells the customer's bond must be fair and reasonable.