The Bond Buyer
March 16, 2009 Monday
TAXABLE BONDS: Build America Bonds Could Open Up Path to New Investors
BYLINE: Dan Seymour

Congress hopes an expansion of the taxable municipal bond market will introduce new types of investors to state and local bonds.

The new investor types potentially include foreign investors, pension funds, defined-contribution plans, certain kinds of trusts, and any other vehicle that is already tax-exempt or tax-deferred.

The idea is that it doesn't make sense for investors not paying taxes on their holdings to bid for tax-exempt bonds. Historically, yields on munis have been lower than on taxable debt because most investors benefit from a tax exemption, resulting in a higher tax-equivalent yield.

"Why put a tax-free in a tax-free, or even a tax-free in a tax-deferred?" said Lynn Siewart, a pension consultant in Vancouver, Wash. "We would never do that."

Siewart said the tax exemption is the only real barrier between many of his clients and the muni market.

He plans to consider Build America Bonds, and said he would be interested if the price is right.

"We're always looking for fixed-income that makes sense," he said. "We're probably modest buyers for taxable munis, if the yields are decent."

"Modest" is also the word George Friedlander, managing director and fixed-income strategist at Citi, used in a report earlier this month to describe his expectations for issuance under the program.

"Lawmakers appear to be far more enamored of tax-credit bonds than investors, underwriters, or issuers," he said.

Analysts from Barclays Capital estimated issuance of $150 billion over two years under the program.

Build America Bonds enable municipalities to sell taxable bonds and either receive a 35% federal subsidy in lieu of the tax exemption or allow the investor to receive a tax credit.

It remains to be seen whether rates can be competitive with taxable debt like corporate bonds, attracting taxpaying investors that have historically not been interested in munis because of comparatively low pre-tax yields.

"I think they would be attractive in the 401(k), profit-sharing, defined-benefit plan arena," said **Mark Johnson of ERISA Benefits Consulting Inc.**, a plan consultant in Grapevine, Tex.

Johnson said the timing is right because pensions are already moving toward a greater allocation to fixed income.

The turmoil in the stock market and regulatory changes to how these plans account for how well-funded they are have prompted plans to become more conservative, he said.

Munis, which have lower default rates than corporates, would make sense for plans looking to be more cautious, according to Johnson.

Taxable municipal bonds are hardly without precedent. State and local governments often sell bonds that do not qualify for tax exemptions, such as investor-led housing. In the last five years, more than $135 billion of taxable municipals have been issued, according to Thomson Reuters.

Scott Colyer, chief executive officer of Advisors Asset Management in Monument, Colo., said the taxable muni market is currently too small and fragmented to generate significant interest. That could change, he said.

Colyer, whose company plans to be involved with Build America Bonds, anticipates a "hefty appetite" among pension plans, IRAs, and foreign investors.

One impediment is disclosure. Investors in taxable markets are accustomed to greater and more frequent disclosure from issuers than many governments offer.

Colyer believes municipalities will comply with greater disclosure requirements to tap a deeper, more liquid market.

"If they want to access this market, they're going to have to step up their disclosure quite a bit," he said. "The market will demand that issuers of taxable product provide disclosure that is at least close to being that of the corporate world."

Siewart said he will look for several things when these issues come to market. Pricing is paramount.

"We want extremely competitive deals," he said. "If in fact they're not terribly competitively priced, we're going to wait and see what kind of deal we can get."

Another factor is liquidity. When a plan member retires, he needs to be able to start converting his investments into cash.

"We don't want to be stuck with illiquid assets," Siewart said. "Anything in a retirement plan, the less liquid position you have the more difficult a time you're going to have managing it."