RIVERBEND
Capital Advisors

Market Comment 9/17/12

The Cost of Waiting in Muni Bond Investing

Despite robust inflows to municipal bond funds and increased direct retail purchasing over the past few weeks, many investors continue to remain on the sidelines hoping for a better entry point. However, given the Fed's policy stance, money market accounts should generate little income for the next two years. As such, investor's decision to stay in cash has a significant cost-- ***the cost of waiting***.

The concept of ***cost of waiting*** has two main points. First, interest rates may stay unchanged or move lower. If so, by staying in cash, investors would miss coupon income and possible capital gains from investing in longer-term municipal bonds. Second, suppose interest rates do rise after investor's bond purchase. It is important to know what the breakeven levels of interest rates are for a particular horizon date. In this article, we choose two horizon dates for our analysis: one year from today and two years from today.

The 5% coupon bonds offer surprisingly better return profile than the yield levels suggest

Chart 1 shows the current 1-30 year AAA yield curve. This curve assumes all bonds have 5% coupons, which are pervasive in the muni market. One can see that the 10-year AAA yield is 2.29%, and the 30-year AAA yield 4.13%.

Chart 1: Current AAA Yield Curve (%)

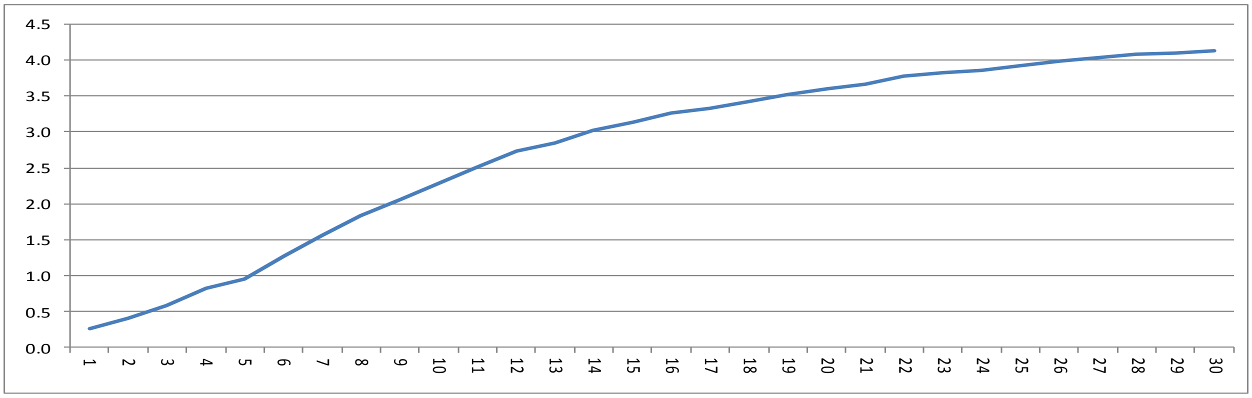
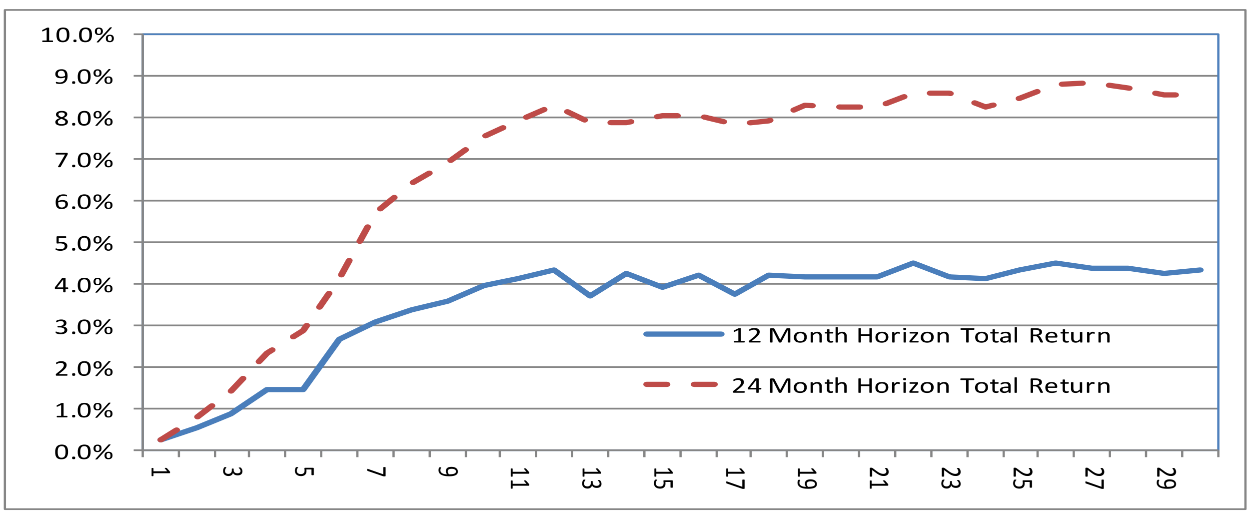


Chart 2 below shows the one year and two year total rate of returns if one buys 5% coupon AAA-rated municipal bonds at each of the 1-30 year maturities today. For example, if one buys a 5% coupon 10-year AAA muni bond at yield 2.29% and the yield curve remains unchanged in 12 months, the total rate of return would be 3.98%. If one holds the bond for two years and the yield curve remains unchanged, then the total return would be 7.57% over that period.

As another example, a 22-year maturity 5% coupon AAA muni has a yield of 3.77% today. The total returns for one year and two years would be 4.49% and 8.61%, respectively, if yield curve remains unchanged.

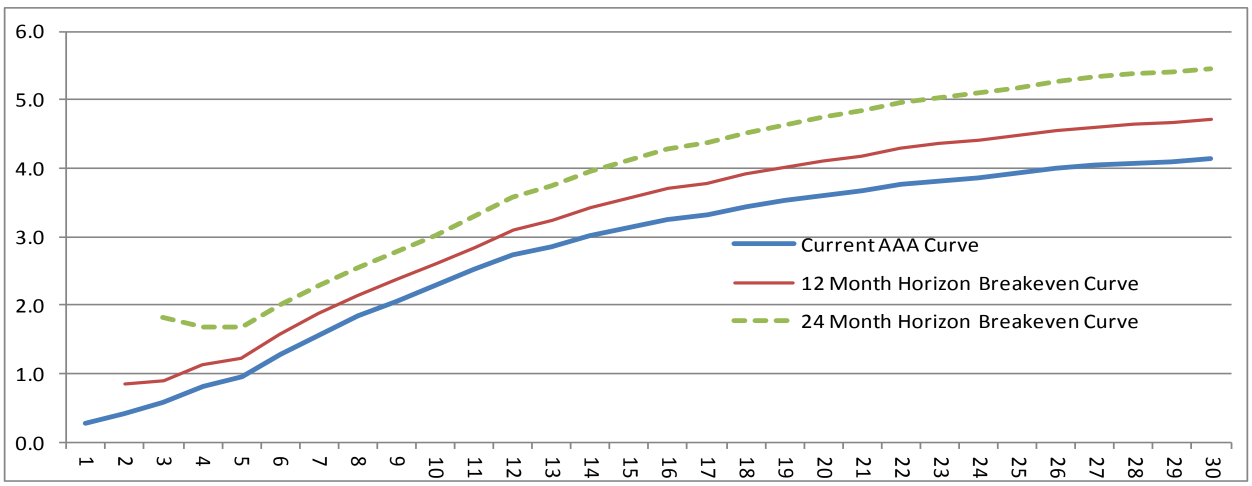


Breakeven interest rate levels

In the examples above, the yield curve is assumed to remain unchanged for the holding periods. If the yield curve moves down, then of course the total returns would be even better.

Now what if yield rises? If one buys a 5% coupon 22-year AAA bond today at a yield of 3.77% and holds for a year, at what yield level would the investor breakeven, i.e., the total return is 0? The answer is 4.30%. If the investor holds the same bond for two years, the yield needs to rise to 4.96% in order to produce a 0 total return. In general, **Chart 3** shows how much the 1-30 year AAA yield curve can shift upward in order for investors to breakeven in a 12 month horizon or 24 month horizon. This shows that investors can tolerate considerable rise in yield, especially for a longer-time holding periods. This is the other side of ***cost of waiting***.

Chart 3: Breakeven Curve for 12 Month and 24 Month Horizon Dates



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