

Subprime crisis breeds opportunity

Liquid long-term munis, their yields identical to taxables', are likely to rebound soon

By Robert N. Gordon

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As shock waves from the subprime meltdown have rippled through the financial markets, they have created a startling opportunity in the otherwise staid market for tax-free municipal bonds.

Liquid long-term munis have reportedly been among the asset classes most affected by the investor sell-off. Recently, tax-free bonds have been so depressed that they are selling at prices where their yields are identical to those of taxables.

Under normal conditions, long-term munis yield about 85% of taxables.

We think this is an aberration that eventually will be corrected. In the past, in fact, when similarly out-of-the-norm yield gaps developed, they reverted to their customary range within a few months.

As a result, we think that current market conditions present an unusual opportunity for long-term-bond investors.

We emphasize long-term bonds because the ratio of short-term munis to taxables has held more stable at about 68%.

The gap between taxable and tax-free yields in short-term instruments isn't as great as in long-term bonds, because investor demand for short-term high-quality munis didn't slip during the recent market crisis, perhaps because investors are driven more by tax considerations than by temporary market dislocations.

So how do you "play" such an opportunity?

If you own long-term taxables, sell them and replace them with tax-frees of equal credit quality. It is interesting to note that "junk" munis have a much better default record than "junk" taxables.

Shifting to an A-rated muni from an A-rated taxable is therefore probably an upgrade in quality when all is said and done.

If they have the stomach and sophistication to do so, investors could buy long-term munis and short long-term Treasuries in such a way as to be theoretically interest-rate neutral.

If you would rather have a professional do it for you, there are muni-arb hedge funds. There are even funds of muni-arb hedge funds, if you would like a diversification of managers.

Understandably, these funds were also hit as the tax-free ratio went from 85% to 100%, but they should be perfectly positioned to make money if and when the ratio snaps back.

While we are on the subject of the ratios between munis and taxables, let me mention a somewhat unconventional, uncorrelated investment that derives its interest coupon from these relationships. It is a five-year structured note that has a principal guarantee and a floating-rate coupon.

The note pays quarterly interest, which is determined by a formula that takes the coupon rate and then adds the difference between 65% and the current ratio of short-term puttable munis to short-term taxables, based on the three-month London interbank offered rate.

For example, the interest on such a note currently would start with a typical 10.4% coupon, plus the difference between 65% and the current ratio, 68%, which is 3 percentage points.

The quarterly annualized coupon, therefore, would be 10.4% minus 3 percentage points, or 7.4%. If tax rates go up — as most expect — this should drive the ratio down, and the coupon on these notes would rise.

Conversely, if tax rates decreased, we would expect an increase in the ratio and a decline in the interest rate paid.

While many events might affect this ratio over the short term, sooner or later, the maximum effective tax rate is going to be the main determinant of the ratio of short-term munis to short-term taxables.

These notes can be seen as a hedge against rising tax rates. Other structures are offered with much higher possible payoffs if the ratio declines, but of course, they carry a lower coupon and more downside possibilities.

With so many sectors exhibiting unusual volatility, the usual staid world of tax-free bonds seems to be a great place to look for opportunity.

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