

Source of the Municipal River

Professional investors use the concept of the “municipal river” to explain the difference between institutional and retail investment in municipal bonds. The municipal river is a metaphor for the bond market and it represents the purchase and sale of municipal bonds in the lifecycle of a municipal bond.

The source of the river is the initial offering of a municipal bond. The issuers of a new municipal bond are motivated to sell all of their bonds quickly into the municipal river. They make their first sales calls to the large institutional investors hoping to sell all of their bonds efficiently in large blocks. These large institutional bond buyers are professional investment managers who manage billions of dollars in municipal bonds. After the institutional buyers purchase all of the new issue bonds that they want, the bonds flow downstream in the municipal river into the secondary market.

Secondary Market

Retail brokerage firms bring municipal bonds into their inventory and then they add a sales commission to motivate their brokers to sell the bonds. The yield to the investor on the bond is reduced relative to the size of the sales commission. Yields are decreased as the municipal bonds flow downstream in the municipal river. Retail investors who buy their bonds downstream are essentially getting the “leftovers” that the institutional buyers didn’t want.

After bonds remain in the retail brokerage firm’s inventory for a few months, the bonds begin to “look stale” and the brokerage firm is motivated to sell them. To accelerate this process, the brokerage firm increases the sales commissions on the bonds to incent their brokers to sell the bonds, which further reduces the yield on the bonds to the end buyer. **Check original bond sale prices as they must be reported and are available to the public in the EMMA database at emma.msrb.org.**

Retail investors who buy their municipal bonds out of the municipal river tend to pay higher prices and potentially earn lower yields, primarily due to the sales commissions that are built into the bonds. Retail investors may not know that their broker is making a sales commission on their purchase of a municipal bond. Retail brokers have a conflict of interest in that they may receive a larger commission to sell a less attractive bond from their firm’s inventory.

Summary

Experienced investors, who understand the conflicts of interest and inefficiencies of the retail bond market, often turn to professional investment managers who have the ability to access municipal bonds at the institutional pricing level. Large institutional buyers monitor the municipal river, patiently looking for attractive opportunities to buy mispriced bonds flowing down the river. These institutional buyers are disciplined and avoid buying bonds at high prices that equate to a lower yield on their bond purchase. Their experienced traders can also buy and sell large blocks of bonds at a low cost.

The moral of the municipal river story is that you may benefit from buying your municipal bonds through a professional institutional buyer with access to the source of the municipal river. Institutional buyers can be accessed through separate account managers, mutual funds, or index funds. Buying your municipal bonds downstream in the secondary market from a retail stockbroker may result in encountering higher costs and more conflicts of interest.

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