Scarsdale Investment Group

The Unbeaten Path to Secure Investment Growth

Comparison of Publicly Traded Fixed Income Muni Debt and Nonpublic Private Debt

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Here is a typical financial/investment conversation that you might have had with your friend or your friendly broker. You were asked what return you were earning on your high-quality bonds, such as publicly traded municipal bonds? You responded 2% to 3% tax-free. We will call this the return on Muni bonds or Muni bond investment in this article.

With a smile you were advised that you were selling yourself short since you could be getting a 10% return on other fixed income investments. We will call this investment Nonpublic or Private Debt in this article.

How could you not inquire how to triple your return? Maybe in this wide world of possibilities, your broker or friend has found that there actually may be a "free lunch" out there and you should seek to triple your investment return. Are you experiencing FOMO – fear of missing out?

Stan had this very conversation recently with a client named Bill, a successful doctor, who actually made such an investment in Nonpublic Debt.

Here is a brief summary of some of the questions you might consider asking and how you might evaluate an investment in Nonpublic Debt in order to answer the question of whether you have grossly overpaid for your Muni bond investment.

<u>Liquidity</u>

What does it mean that this debt is Nonpublic or Private Debt? It is still a debt of the issuer, right? Yes, it is, but all debt is not the same.

Public debt, such as Muni bonds, is traded in a public market and you can find a trading history. In addition, when you want to sell you can find multiple buyers. You might get more or less than you paid for your Muni bonds, but you can sell your bonds in a short period of time at a reasonable price. In finance-speak, this is called "liquidity".

The Nonpublic or Private Debt may not be liquid at all. In fact, it may be illiquid. The only buyer may be the issuer of the debt, assuming that buyer actually wishes to buy and has the cash to buy.

OK, so let's assume that the company that is the issuer of the Private Debt says that it will offer to buy back its Private Debt, but only once a year, on each December 31, if you give 90-days' notice. Suppose you read the fine print which states that there is a limit to the size of the annual redemptions. In addition, consider that the company at some time may be illiquid and may not be financially able to redeem any of its Private Debt. Does that reduce the value of your Private Debt compared to your Muni bond investment that you can sell at any time?

The question of liquidity, is a key concept in the fixed income market. Who stands ready to buy your debt? So, your first investigation should be to determine the financial strength of the issuer (the seller of the Private Nonpublic debt). What are the terms under which you can sell your Private Debt and how likely is it that the issuer will be able to continue to pay your 10% return?

OK, let's assume that the issuer is sound, high quality, good reputation, great human beings. So, are we done here? Well, no. All we have established is that the issuer is sound as of today. What about when you want to or need to sell or when the Private Debt comes due? Will the issuer still be sound? Will the ownership be the same?

That bears repeating: Will the ownership be the same? One of the great stories relating to this is <u>Barbarians at the Gate</u> by Bryan Burrough and John Helyar. It is the story of the takeover of RJR Nabisco by Kohlberg Kravis, when F. Ross Johnson was the Chief Executive Officer of RJR. The poem is sung to the music of Frosty the Snowman.

> F. Rossi the snowman had a triple comma dream,
> You can have the skim milk and I'll make do with cream.
> Hey all you bucolics, here's a deal that's really sweet.
> You take title to the chaff and I'll haul off the wheat.[i]

<u>Valuation</u>

Did your broker or friend evaluate the financial strength of the issuer of this Nonpublic Debt? Do they have the expertise to make this determination?

The value of Nonpublic or Private Debt is subjective. Substantial fees may be paid to an advisor to do the evaluation of value, and those fees are based on the evaluation of the assets. Yes, that's right. The higher the valuation, the higher the fees.

There may be a history of operating losses and it may be unclear whether the company will achieve profitability. The company issuing Private Debt may be highly leveraged (has issued a lot of debt) to increase its return. The use of high leverage will substantially increase your risk.

Compare the Nonpublic Debt to a Muni bond investment. Evaluation of the debt of the Muni bond is set by independent valuation agencies. Trades are reported continually. You can sell your Muni bonds whenever you want. In addition, you don't have to sell to realize liquidity if you can wait until the bonds are called or come due.

The issuer of Private Debt generally has no or few legal constraints on whether it can:

- Issue more debt. It might issue a lot more debt making a sound company a poor credit risk.
- Sell the company to a buyer. In this case, everything you learned about the issuer is "old news". There is a new sheriff in town. The new owner of the company may be better or worse. However, all your investigation of the old issuer is useless.

Payment of Interest

Where does the issuer get the cash to pay you the 10% interest on your investment? When you purchase a municipal bond, you can find that there are discreet sources of revenue that support your bonds. If the municipality cannot pay interest, this is considered a default. It has implications for the municipalities' ability and the States' ability to borrow in the future in the bond market.

On the other hand, the issuer of Private Debt may pay distributions from sources other than cash flow from operations. Other sources of revenue include sale of some of its assets, borrowings or offering proceeds. In other words, you may be getting what you consider to be income, but at the same time the value of the company may be undermined and depleted.

Fees, Taxes and Bad Timing

When comparing Private Debt and a Muni bond investment, your analysis should take into account taxes, fees and bad timing. Private debt has potentially many different types of fees, including ongoing and exit fees.

No analysis is complete without considering the after-tax return. Though tax proposals may never become reality, they are worth considering when you make a long-term investment. Taxes on ordinary income may be increased to 39.6 percent. Under the Biden plan, long-term capital gains may be set to ordinary income rates for those earning over a million dollars. As they say, once the camel's nose is under the tent you can be sure that bracket will be expanded to lower income individuals, like the Alternative Minimum Tax. You cannot predict the tax situation when you decide to liquidate. States and Cities continue to increase their income taxes as well.

You can find Muni bond investments that are free of Federal income taxes and possibly state and local income taxes as well. Municipalities vigilantly protect their tax-exemption. Once you buy your Muni bonds, there are no further fees. And finally, your Muni bonds will come due or be called without you having to find a buyer or time the investment.

Tax-Reporting

What is the tax-reporting for this particular investment? Many Nonpublic companies issue a K-1 instead of a 1099. A K-1 may add a large amount of complexity to your tax return. In addition, it may not be issued until late in the year.

Compare this to the 1099 reporting of your Muni bond interest which is quite simple and generally tax-free.

The Difference

What does the Muni bond investment have that may be unavailable with Private Debt?

- Muni bonds have one or more bond ratings: a third-party evaluation of the strength of the issuer.
- Liquidity: You can sell at any time. Furthermore, it will self-liquidate when called or when it comes due. Individual bonds are the only asset to self-liquidate.
- Reliability: You know you will get timely interest payments on high quality Muni bonds.
- Tax-free income.
- Legal constraints on debt issuance.
- Legal constraints on leverage.

Summary

Let’s get back to the original question: How do you equate your 2-3% return on a publicly traded Muni bond which has an AA or AAA rating and has passed through significant underwriting by a major financial institution and also has a legal option as to the veracity of its prospectus with the Nonpublic or Private Debt in our case?

The answer to this question is that the Private Debt and the Muni bond investment are not comparable.

And here is the bottom line. The Private Debt has a high current return, but there is a *substantial risk of the return of some or all of your principal.* The Private Debt is a risk asset similar to stock, commodities or real estate. What does the supposed 10 percent return look like if you may lose a significant amount of your principal or if you can’t sell it?

Though we have focused on Private Debt, similar concerns exist for other Alternative Investments, such as hedge funds, non-traded Real Estate Investment Funds (REITS), Private Equity and Business Development Companies.

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[i] Bryan Burrough and John Helyar. Barbarians at the Gate. Harper & Row, 1990. P. 506