SCARSDALE Investment Group
The Unbeaten Path to Secure Investment Growth

How to Evaluate a Municipal Bond

By Stan Richelson and Hildy Richelson   March 19, 2024

We recently received a call from a client. He asked us how we would evaluate a municipal bond that was offered to him by a broker. Here are some thoughts.

All bonds share a defined structure. What differentiates one from another is the quality and quantity of each of the ten parts of a bond that are set forth below.[i]

Parts of a Bond:

1. Face Amount– The funds returned to you when the bond matures.
2. Coupon – The interest rate payable semi-annually for the life of the bond.
3. Issuer – The entity that is going to pay the interest on the bond and return your principal on the due date.
4. Maturity – Final outstanding date for the bonds. Also called due date.
5. Call Date(s) – When a bond can be paid off prior to maturity by the issuer.
6. Yield-to-Maturity – The yield the bond will earn if held to its due date.
7. Yield-to-Worst Call– The lowest interest rate that you can earn on a bond.
8. Price – The amount you pay to buy the bond.
9. Rating – Moody's, Standard & Poor's (S&P) and sometimes Fitch Ratings.
10. Tax Implications – Important to know before buying a bond.

The Broker Offering to Our Client:

Face Amount: Two bonds ($2,000)

Issuer: Entertainment Center Community Facility District Arizona. It is a Revenue bond, meaning that the source of payment was from a lease.

Coupon: 4 percent

Maturity: July 1, 2037.

Call Date: July 1, 2027@100. It also has a July 1st annual Sinking Fund[ii] that started in July 2018.

Price: 100, so that the yield-to-maturity and yield-to-call were both 4%.

Ratings: There were no ratings by Moody's or S&P, but there was an AA+ rating by Fitch.

Our Evaluation

Face Amount: The position is too small ($2,000). The smallest muni bond size is 5 bonds ($5,000). This position might be very difficult to sell if a sale were desired in the future.[iii]

Rating: There is no rating by the usual municipal credit rating services – Moody's and S&P. AA+ Fitch Ratings is a strong rating. The agency saw the tenant as a strong source of lease payments.

Price: Offered price to our client (100) was a market price for five bonds or more. It was out-of-line with the actual market price of 95.68 on 3/14/2024 for two bonds.

Yield-to-Worst Call: At a price of 95.68, the yield-to-call was 5.451 percent if the bond were called July 1, 2024, the sinking fund date. There is about a 5 percent possibility of the bonds being called on that date. The yield-to-maturity was 4.433 percent if the bond came due on July 1, 2037, its due date.

Tax Implications: If the bonds were purchased at 95.68%, it would result in a taxable gain when the bonds were called or came due. That is not a factor if the bonds sell at par, the round lot price. The bonds were in-state for the client, so the client would not have incurred any Arizona tax.

Conclusion

We suggest that when you buy a bond, do your research and buy the highest quality bonds. This will enable you to:

- Buy them and forget them. You will not have to track the market or constantly review your holdings.
- Build a sustainable cash flow as a second income stream.

Though high-yield bonds and high-yield bond funds are heavily advertised in a good market, you may not be able to sell at a favorable price in a market downturn. Picture everyone trying to squeezing through the door at the same time.

We hope that our basic bond evaluation methodology is useful to you.

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[i] For a more detailed description of the essence of a bond, see our book: BONDS: The Unbeaten Path to Secure Investment Growth, 2nd edition, John Wiley, Chapter 5.

[ii] A sinking fund is a call, which requires the issuer to redeem a set portion of bonds in specified years. The original size of this deal was $16 million. As a result of the sinking fund calls, the outstanding size is $12,315,000.

[iii] If $5,000 is a smallest denomination of a tradeable municipal bond, you might ask: How do you get a municipal bond selling for a face amount of $2,000? Managed accounts will often purchase a large position and allocate a portion to specified accounts. They will sometimes split a bond into unsaleable lots.