

Municipal-Bond Fans Get a Rude Awakening

Call Feature Can Catch Investors and Money Managers Off Guard; New York City's \$430 Million

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February 8, 2005; Page C1

Last week brought a big improvement to the \$2 trillion municipal-bond market, where investors can now check the prices at which bonds trade with only a brief delay.

But it also brought a wake-up call for investors about one of the pitfalls of investing in this popular corner of the bond world. A week ago today, New York City began redeeming \$430 million in municipal bonds, socking some investors with

losses of 15% or more in bonds that carry a rock solid triple-A rating. In all, brokers estimate that about \$50 million in market value has evaporated.

The losses stem from investors' misunderstanding of a common bond feature known as the call. When borrowers redeem, or call, their bonds, they are essentially paying back bond investors early. Overall, about 78% of new municipal bonds sold last year can be called before they mature, according to Thomson Financial, though many of them are trading at prices that take this into account.

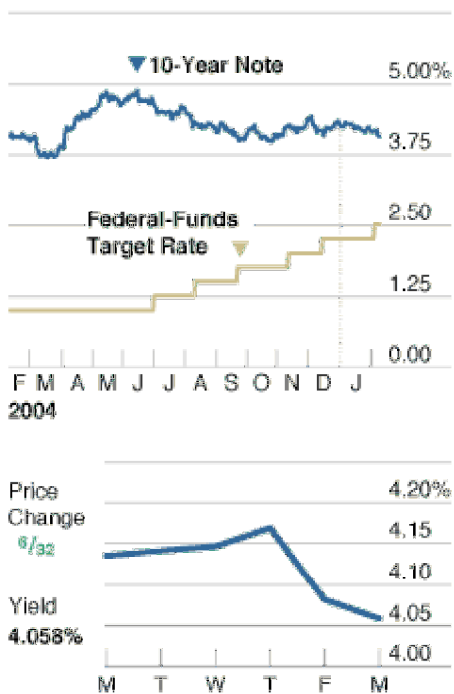
In the case of the New York municipal bonds, however, investors didn't expect a call and many had bought them last year in the secondary market at prices that were \$10 or \$20 above the \$100 face value of a bond. These investors were attracted by the bonds' high yields. But the bonds fell sharply in price in November, when the city announced its plan, with those set to mature in 2012 through 2019 falling between 12% and 17%. New York is now redeeming the bonds at or slightly higher than their face value, locking in the losses.

Like many municipalities, New York had always reserved the right to redeem the 63 individual bond issues it is calling as part of its debt refinancing. But investors and even some brokers who sold the bonds to their clients didn't expect the city to do so since it had already refinanced the debt in the early 1990s and couldn't tap the tax-exempt bond market for another refinancing under Internal Revenue Service rules. In an unusual transaction, New York City decided to replace the bonds by issuing taxable bonds instead.

"Unfortunately, it's the small investor who takes the hit," says William Hutchinson, a New Jersey broker

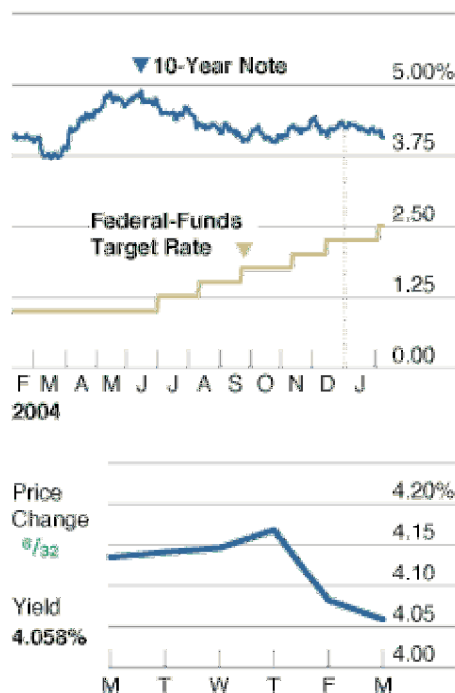
10-YEAR TREASURY NOTE YIELD

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who sold the bonds to about half a dozen clients who will lose money on them. He says one client, a retired clothing designer in her 70s, will lose more than \$100,000 when all of her bonds are redeemed. "When you're in a triple-A bond, you assume you're in a safe security," he says. "This came out of nowhere."

Raymond Orlando, head of investor relations for the city, declined to comment on the plight of investors. "This was a highly unusual transaction," he says, that will save the city \$48 million. New York is redeeming old bonds that paid a high interest rate of 6% to 8% and replacing them with new bonds that pay lower rates of 3% to 5%. Merrill Lynch & Co., the Wall Street firm that arranged the deal and handled the sale of the new bonds, declined to comment.

Individual investors attracted to the tax advantages of municipal bonds make up a large part of the market. About one-third of outstanding municipal bonds are held directly by individuals and another third are held through mutual funds. But on any given day, only about 10,000 out of the 1.3 million to 1.5 million municipal bond issues actually trade in the secondary market. New York City has about \$30 billion in bonds outstanding, about 1.5% of the total in municipal bonds.

Money managers are sometimes surprised when bonds are called, too. Ken Woods, president of Asset Preservation Advisors, a municipal-bond investment firm in Atlanta that has about \$500 million under management, says his clients lost about \$75,000 in market value on Wyoming prison bonds when they were called unexpectedly in September and \$30,000 in market value when some Columbia County, N.Y., bonds were called in 2003. He adds that the losses were all on paper and his clients made money overall because he had bought the bonds earlier at prices below the call price.

Bond investors who pay a premium price for a bond that can be called are "taking an enormous risk," he says. When bonds that investors don't expect to be called are redeemed, "someone gets hosed."

Brokers are required to provide investors with a written disclosure about a bond's call features, usually in purchase confirmations. In December, Morgan Stanley agreed to pay more than \$300,000 in fines and restitution to settle charges brought by the National Association of Securities Dealers that it failed to disclose the call features on municipal bonds its brokers sold to investors from 1997 to 2002. The securities firm didn't admit or deny the allegations.

Surprise calls are "a disservice to the market," says Kevin Olson, an investor advocate who runs a municipal-bond Web site. "It needs to be clearer whether these bonds are callable or not."

Mr. Hutchinson, the New Jersey broker, says he told clients about the possibility of a call, but added that he considered it remote since New York could have called the bonds for years, but hadn't done so.

After the city announced its plan, Mr. Hutchinson's firm, Hunter Securities, sent a letter of complaint, arguing that the city should have considered the effect on bondholders when it made the move. So far, he says, the city hasn't responded. But clients have given Mr. Hutchinson an earful, saying they won't buy any more New York bonds, he says.

Adding to the confusion, both the New York City bonds and those sold by Morgan Stanley were backed by U.S. government securities held in escrow to pay bondholders until the bond matures. These type of bonds are known as escrow-to-maturity bonds, which might sound like a guarantee that the bond won't be redeemed early but isn't.

"The disclosure has been a little weak and the understanding among investors even weaker," says Peter Coffin, president of Breckinridge Capital, a Boston money manager specializing in municipal bonds. "It's a very sticky area."

Yesterday's Treasury Trading

Prices of longer-dated Treasurys surged, while very short maturities fell slightly. Analysts cited factors ranging from further repositioning after Friday's employment report to wagers that yields of short issues would continue to rise in relation to those of longer Treasurys -- which is termed a flattening of the yield curve.

Shorter issues also faced pressure ahead of this week's Treasury refunding auctions, which comprise \$22 billion in three-year notes Tuesday, \$15 billion of five-year notes Wednesday and \$14 billion of 10-year issues Thursday.

At 4 p.m. Monday, the benchmark 10-year bond was up 6/32 point, or \$1.875 per \$1,000 face value, at 101 17/32. Its yield fell to 4.058% from 4.081% Friday, as yields move inversely to prices. The 30-year bond was up 30/32 point at 114 17/32, to yield 4.429%, down from 4.484% Friday.

Corporate Bonds

Pulte Homes raised \$650 million in a two-part deal. Its \$350 million of 10-year, 5.20% bonds were priced to yield 5.224%, or 1.18 percentage points over Treasuries. Another \$300 million in 30-year, 6% bonds were priced to yield 6.019%, or 1.60 percentage points over Treasuries. Rated Baa3 by Moody's Investors Service and triple-B-minus by Standard & Poor's, the issue was led by Barclays Capital, Deutsche Bank Securities, Merrill Lynch & Co. and UBS Securities.

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