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Municipals and the Volume Premium

The volume discount is one of the first and most elementary lessons we learn in business. But in the municipal bond market, you might be surprised to find that just the opposite is true. How can that be? Why would I usually pay more, and receive lower yields, when I buy larger lots? The answer is simple. It is supply and demand. The larger the lot, the more demand resulting in higher prices and lower yields.

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This is not the appliance business, where three stoves cost the retailer more per unit than three truckloads of stoves. And it's not like buying stock where the commission per share is less for a larger order.

This is the municipal business, where billions of dollars of institutional demand for larger lots drive up the prices. In fact, in the municipal market, the price differential for larger lots progresses in almost perfect sequence. A 10 bond piece will usually yield more (sell cheaper) than a 25 bond lot and 25 bonds are generally cheaper than a 100. And up the ladder it goes as the smaller institutions and bond funds begin to compete. One hundred are usually cheaper than 250 and 250 are usually cheaper than a million-bond lot. This price differential usually creates a uniquely advantageous opportunity for individual investors. So rather than focusing on larger lots, you should consider smaller lot sizes where you can usually get higher yields.

Trying to compare one offering to another can be quite confusing, but if done properly, it is easy to do. Remember, with bonds, prices and yields move in opposite directions, which means when we say cheaper, we're referring to higher yields. So when comparing one municipal offering to another, first make sure the offerings are the same in terms of quality and maturity. Then make a comparison based on yield to maturity. (Don't make the mistake of comparing dollar prices, because unless comparing identical items, you won't get a meaningful conclusion.)
When thinking about municipals, forget volume discount and remember you almost always get lower yields with larger lots. The proof is in the pricing of primary market issues. The municipal market is actually a combination of two closely related markets: the primary market, where dealers purchase bonds directly from the issuer, and the secondary market, which includes bonds issued as recently as yesterday or as much as thirty years ago. The secondary market accounts for approximately 80% of the total municipal market, and as most sophisticated individuals know, it is where the best prices are usually found. That's because the new issues are offered in larger lot sizes and therefore eagerly sought after by the large institutions with billions to invest. Obviously, this increased demand for larger lots forces their yields lower.

Stop thinking like a stock investor where the hot new IPO's often trade right up in price. The Municipals market is different, and it is not unusual for new issues to soon trade at lower prices.

It is almost always a mistake for the individual investor to buy 5 to 25 bonds in the primary market, because you're paying the higher large lot price for smaller lots.

The one disadvantage is that the smaller lots will cost you more if you have to sell. However, if you are a buy and hold investor, you may be in a position to take advantage of the higher yields while avoiding the higher selling spreads.

One final point

Years ago when municipals were issued in bearer form, buying in smaller lots required a lot more maintenance. However, now that bonds are issued in book entry form and held in safekeeping, the only extra effort required to get the higher yields is a few more minutes spent reading your monthly statement. We think the extra yield is well worth a few more minutes once a month.

Of course, for those investors who prefer larger blocks, we'll be happy to provide you with the most competitively priced lots of 250,000 to a 1,000,000, or more. We welcome the opportunity.

Although the above information and statistics are not guaranteed, they have been obtained from reliable sources and are believed to be accurate.