Understanding the Municipal Bond Marketplace and the New Issue Process

November 3, 2016

Phillip Breeding, Regional Consultant
Debra Saunders, Vice President
Euriah Bennett, Vice President
Agenda

• Overview of the municipal bond market
• Understanding municipal bond interest rates
• The primary market
• Fidelity’s involvement in municipal finance
• Appendix: Advanced topics
Overview of the municipal bond market
Municipal bonds in perspective

- The municipal bond market is fragmented and idiosyncratic
- $3.8 trillion in outstanding municipal bond debt
- There are over 31,000 different municipal bond issuers with bonds outstanding in the USA
- Individuals hold 43% of municipal bonds

Total U.S. bond market debt as of 2Q16*

![Pie chart showing distribution of total U.S. bond market debt as of 2Q16.]

Holders of U.S. Municipal Securities*

![Bar chart showing holders of U.S. Municipal Securities from 2004 to 2016.]

* in billions

Source: SIFMA as of June 30, 2016
Understanding municipal bond interest rates
What determines interest rates on municipal bonds?

- Treasury Rates: Generally Inflation and other economic activity
- Treasury bonds are the “benchmark” rate -- Aaa UST vs Aaa Muni
  - Comparisons throughout the curve
  - Taxable vs tax exempt
- Supply: Abundance or scarcity of tax-exempt bonds available on the market
- Demand: Money flows between stocks and bonds
  - Liquidity (short-term) or yield (long-term)
  - Different categories of investors

For illustrative purposes only
History of Muni/Treasury relationship

- Prior to 2007-2008 financial crisis 10 year AAA MMD/Treasury ratios hovered in the 75% -85% range
- Since the financial crisis, ratios have remained above historical averages
- Low Treasury yields have been driven by US Federal Reserve policy.
- Municipal yields have not fallen in concert with Treasury yields. Ratios have increased with lower Treasury yields
Taxable-equivalent yields for individual bonds

This table compares "Tax-Equivalent Yields," the before-tax yields needed for different bond types to have the same after-tax value. Thus, the higher a bond's displayed yield, the more taxes incurred. Your bond is highlighted in yellow. Learn more.

<table>
<thead>
<tr>
<th>Tax-Equivalent Yields Based on Security Type</th>
<th>In-State Municipal</th>
<th>CDs</th>
<th>Corporate</th>
<th>Out-of-State Municipal</th>
<th>Treasury and Agency/GSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.50%</td>
<td>3.97%</td>
<td>3.93%</td>
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<td>3.73%</td>
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<td>2.36%</td>
<td>1.55%</td>
<td>2.24%</td>
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Applicable Taxes on Interest Income *

<table>
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<tr>
<th>In-State Municipal</th>
<th>CDs</th>
<th>Corporate</th>
<th>Out-of-State Municipal</th>
<th>Treasury and Agency/GSE</th>
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<tr>
<td>None</td>
<td>Federal, State &amp; Local</td>
<td>Federal, State &amp; Local</td>
<td>State &amp; Local</td>
<td>Federal</td>
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</table>

* The impact of federal and/or state alternative minimum taxes are not reflected in this analysis.
Understanding credit – types of bonds and credit quality

- What is the security?
  - General obligation or revenue, what type of revenue?
- What is the source of repayment (if different than the security)
- What are the bondholder protections (debt service coverage rate covenant, parity bond test, reserve fund)
- What are the ratings? Any recent changes?
- What is the underlying economic base, including tax or revenue base, growth or contraction, industry/taxpayer diversity or concentration?
- Financial condition, including general reserves, primary revenue source, debt burden and pension funding?
- What are the risks (see Official Statement)?

Source: The Bond Buyer, Market Statistics, October 24, 2016
An official statement is a document prepared by or on behalf of a state or local government in connection with a new issue of municipal securities. The official statement is comparable to a prospectus for a corporate equity or debt offering.
• **General Obligation Bonds**

A general obligation bond is repaid from any general revenues of the state or local government. This type of bond is also sometimes known as a “full faith and credit” bond. In most cases, the state or local government has agreed to levy taxes in an amount sufficient to make payments of principal and interest on outstanding bonds.

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**Revenue Bonds**

A revenue bond is repaid from a specified stream of revenues such as revenues from a project, program or system that the bond is financing, e.g., housing revenue bonds. The ability to raise revenues or taxes to pay debt service is specific to the issue.
Bond sector spreads

- Spreads remain compressed across sectors
- Spreads may reflect credit quality, liquidity, duration, and other factors
- Spread on taxable muni index wider than on corporate index
- Investment grade tobacco sector has widest spread among tax-exempt sectors
Why participate in the new issue market?

1. **Retail Priority**
   - **Order Priority** (usually): Individuals place orders BEFORE Institutional Investors (FMR/Pimco)
   - **Allocation Priority**: Individual investors get allocation review before institutional investors

2. **Transparent Pricing**
   - Bonds are sold at the same price as institutional investors
   - Fidelity’s Online platform makes it easy

3. **No Mark Up**: New issue municipal bonds have no additional mark-ups for individuals investors*
   - Issuer pays the transaction costs

4. **Up-to-date Disclosure Documents & Ratings**
   - Access to current disclosure documents

5. **Call Optionality**: Call dates are furthest out in a bond’s life

6. **Recurring Investment Opportunity**: Certain issuers come to market regularly, providing individuals with multiple investment opportunities in a name and credit

* Fidelity makes new-issue municipal bonds available without a separate transaction fee. Fidelity Brokerage Services LLC and National Financial Services LLC receive compensation for participating in the offering as a selling group member or underwriter.
The primary market
Where to find new issue municipals on Fidelity.com

Research > Fixed Income, Bonds & CDs drop-down on Fidelity.com

- Search for Individual Bonds, Municipal , New Issue
- Or... look in the Fixed Income Carousel for the featured transactions

For illustrative purposes only
Go directly to web address: www.fidelity.com/newissuemunis

All bonds on the new issue page are ALWAYS offered at the new issue price or better

<table>
<thead>
<tr>
<th>Number of Offerings</th>
<th>Document Type</th>
<th>State</th>
<th>Issuer</th>
<th>Maturity Date</th>
<th>Rating</th>
<th>Underlying Rating</th>
<th>Issue Size</th>
<th>Expected Order Period</th>
<th>Settlement Date</th>
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<tr>
<td>View Closed Offerings(20)</td>
<td>Preliminary Official Statement</td>
<td>NE</td>
<td>NEBRASKA INVESTMENT FINANCE AUTHORITY, SINGLE FAMILY HOUSING REVENUE BONDS 2016 SERIES C</td>
<td>03/01/2018-28 &amp; 36</td>
<td>NR</td>
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<td>71,010,000</td>
<td>ORDER PERIOD OVER. AWAITING ALLOCATIONS.</td>
<td>11/30/2016</td>
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<td>NEW MEXICO MORTGAGE FINANCE AUTHORITY, SINGLE FAMILY MORTGAGE PROGRAM CLASS I BONDS, 2016 SER C-1</td>
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</table>
## Methods of sale and participation on Fidelity

- Competitively bought and negotiated balances – OPEN ORDER PERIOD
- Order period open or coming soon – RETAIL ORDER PERIOD

<table>
<thead>
<tr>
<th>View Offerings</th>
<th>Preliminary Official Statement</th>
<th>OR</th>
<th>Description</th>
<th>Date</th>
<th>Rating</th>
<th>Refd</th>
<th>Amount</th>
<th>Order Period</th>
<th>Date</th>
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<tbody>
<tr>
<td>23</td>
<td></td>
<td>SD</td>
<td>SOUTH DAKOTA HEALTH AND EDUCATIONAL FACILITIES AUTHORITY, REVENUE BONDS, SERIES 2016</td>
<td>TBD</td>
<td>NR</td>
<td>A+</td>
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<tr>
<td>3</td>
<td>Preliminary Official Statement</td>
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<td>BRYAN, TEXAS, WATERWORKS AND SEWER SYSTEM REVENUE BONDS, SERIES 2016</td>
<td>07/01/2024-36</td>
<td>NR</td>
<td>AA-</td>
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<td>2</td>
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<td>PROSPER INDEPENDENT SCHOOL DISTRICT, TEXAS, UNLIMITED TAX REFUNDING BONDS, SERIES 2016</td>
<td>02/15/2024-49</td>
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<td>AAA</td>
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<td>1</td>
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<td>CARROLL INDEPENDENT SCHOOL DISTRICT, TEXAS, REFUNDING BONDS, SERIES 2016</td>
<td>02/15/2019-20, 22-25, 30-31 &amp; 33</td>
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<td>AAA</td>
<td>--</td>
<td>--</td>
<td>5,195,000</td>
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</table>
### Understanding the order period (negotiated underwriting)

<table>
<thead>
<tr>
<th>Phase</th>
<th>Action items</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Get Ready</strong></td>
<td>✓ Sign up for alerts – State specific? ✓ Read the Preliminary Official Statement</td>
</tr>
</tbody>
</table>
| **Pricing consensus by underwriting team and issuer** | ✓ Retail order period opens  
✓ Place indications of interest  
  - [www.Fidelity.com/newissuemunis](http://www.Fidelity.com/newissuemunis)  
  - 1-800-544-5372 |
| **Final Pricing**                          | ✓ Final yields/coupons agreed upon by underwriters and issuer  
✓ Lower rates/ability to withdraw order |
| **Allotments**                             | ✓ Retail priority/Allotments are not guaranteed. Allotted bond par amounts may be lower than orders placed. |
Multiple maturities to choose from

<table>
<thead>
<tr>
<th>Issue Description</th>
<th>Expected Coupon</th>
<th>Maturity Date</th>
<th>Rating</th>
<th>Underlying Rating</th>
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<tr>
<td>ULSTER COUNTY, NEW YORK, PUBLIC IMPROVEMENT BONDS 2013 Official Statement</td>
<td>2.50%</td>
<td>11/15/2021</td>
<td>--</td>
<td>AA</td>
</tr>
<tr>
<td>Participate</td>
<td>2.50%</td>
<td>11/15/2021</td>
<td>--</td>
<td>AA</td>
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<tr>
<td>ULSTER COUNTY, NEW YORK, PUBLIC IMPROVEMENT BONDS 2013 Official Statement</td>
<td>3.00%</td>
<td>11/15/2022</td>
<td>--</td>
<td>AA</td>
</tr>
<tr>
<td>Participate</td>
<td>3.00%</td>
<td>11/15/2022</td>
<td>--</td>
<td>AA</td>
</tr>
<tr>
<td>ULSTER COUNTY, NEW YORK, PUBLIC IMPROVEMENT BONDS 2013 Official Statement</td>
<td>3.00%</td>
<td>11/15/2023</td>
<td>--</td>
<td>AA</td>
</tr>
<tr>
<td>Participate</td>
<td>3.00%</td>
<td>11/15/2023</td>
<td>--</td>
<td>AA</td>
</tr>
</tbody>
</table>

Is the bond call protected? Taxable equivalent

Cash Distribution (Estimated Interest & Principal)

Yield to Worst case

Settlement date

As of 11/13/2013 at 11:42 a.m.

Select Chart: Cash Distribution

View as table

What does this chart show?

Hover your cursor over the bars below to view more detail.
• Alert #1 – Preliminary Official Statement is released by the issuer

• Alert #2 – pricing and expected yields released, order period begins

• Alert #3 – final pricing released, if yield is lower, opportunity to rescind order

• Alert #4 – notice of your allocation
Turn here: resources on www.fidelity.com

- www.fidelity.com/newissuemunis
- www.fidelity.com/viewpoints
- www.fidelity.com/fixedincome
- Third party analysis (S&P credit reports)
- Municipal Market News

Outside Fidelity:

www.finra.org/brokercheck
www.invsestinginbonds.com (SIFMA)
www.msrb.emma.org
Issuer investor web pages such as www.buycaliforniabonds.com
Fidelity’s involvement in municipal finance
Mission: Provide Fidelity’s clients with ongoing access to diverse high quality bonds from municipal issuers across the country through our competitive and negotiated transactions

- For example, in California, Fidelity participates in municipal bond offerings for the largest and most active issuers in the state, encompassing various types of debt.

- The opportunity to participate in municipal bond offerings can take several years of coverage:
  - Issuer visits to explain platform
  - RFP Responses (for pool and for individual transaction)
  - Transaction oversight (due diligence, structure review)
When compared to key competitors, what’s unique about Fidelity?

Importantly we are in many of the same transactions as our competitors but provide a different approach to the new issue platform:

1. **Online platform**
   - Ease of participation
   - Online access to POS
   - Online access to tools and educational materials

2. **Advocacy for individual investors**
   1. Order period, regional preference when appropriate
   2. Structure of transaction

3. **Order cancellation opportunity if yields are adjusted lower when final price set**
## Types of common revenue bonds

<table>
<thead>
<tr>
<th>Purpose/Type of Bonds</th>
<th>Typical Sources of Funds to Repay Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Water and Sewer</td>
<td>Water and sewer fees, usually based on water usage if water or combined, flat fee if sewer alone.</td>
</tr>
<tr>
<td>Electric Utilities</td>
<td>Retail electric rates and charges or &quot;take or pay&quot; contract revenues for electric wholesalers</td>
</tr>
<tr>
<td>Housing</td>
<td>Mortgage repayments plus prepayments, mortgages may be federally guaranteed.</td>
</tr>
<tr>
<td>Waste Disposal</td>
<td>Sanitation collection charges, hauler franchise fees, tipping fees, waste burning power sales revenues</td>
</tr>
<tr>
<td>Higher Education</td>
<td>Tuition and fees, room and board, earnings on endowments, auxiliary revenue and state support (for public universities)</td>
</tr>
<tr>
<td>Airports</td>
<td>Airline landing fees, concession and/or rent revenues, passenger facilities fees</td>
</tr>
<tr>
<td>Highways and Roads</td>
<td>Motor vehicle license or use taxes, fuel taxes, federal grants, tolls</td>
</tr>
<tr>
<td>Mass Transportation</td>
<td>Fare box, state sales taxes, facility or equipment lease rental payments, concession revenues. Often subsidized by motor fuel taxes, or with dedicated tax such as a sales tax.</td>
</tr>
<tr>
<td>Project Revenue</td>
<td>Project-specific revenues, such as revenues from a stadium or parking garage. May include guarantees from local governments or dedicated taxes.</td>
</tr>
</tbody>
</table>
### Revenue bond advanced concepts

<table>
<thead>
<tr>
<th>Bondholder Protection</th>
<th>What it does</th>
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</thead>
<tbody>
<tr>
<td>Bond Indenture/Trust Agreement/Resolution</td>
<td>Legal document authorizing the bonds and setting out certain legal provisions and obligations of the issuer to bondholders</td>
</tr>
<tr>
<td>Flow of Funds aka the “Waterfall”</td>
<td>Captures revenues and directs to trustee or paying agent, sets priority of payments. Keeps funds in trust until debt service is provided for</td>
</tr>
<tr>
<td>Additional Bonds Test</td>
<td>Issuer can only issue additional bonds from same revenue source if it can prove it will have certain pre-determined coverage level after issuance</td>
</tr>
<tr>
<td>Rate Covenant</td>
<td>Promise to set revenues high enough to pay debt service</td>
</tr>
<tr>
<td>Reserve Fund</td>
<td>Separate account of money held specifically for bond holders, may only be released back to issuer once bonds are paid off.</td>
</tr>
</tbody>
</table>

- **Net Pledge**: \((\text{Revenues} - \text{Operations & Maintenance})/\text{Debt Service}\) = Coverage
- **Gross Pledge**: \(\frac{\text{Revenues}}{\text{Debt Service}}\) = Coverage
- **Parity Debt**: All debt equally and ratably secured by a particular revenue stream. Example, Los Angeles Department of Water and Power Senior Lien Electric Revenue Bonds.
## Issue Details

**STATE OF CALIFORNIA, CALIFORNIA TAX-EXEMPT VARIOUS PURPOSE GENERAL OBLIGATION BONDS (CA)**

- **Dated Date:** 04/28/2016
- **Underwriting Spread Amount:** Not Disclosed - Competitive Sale
- **Closing Date:** 04/28/2016
- **Time of Formal Award:** 04/19/2016 04:57 PM
- **Time of First Execution:** 04/20/2016 09:30 AM

### Maturities and Issue-related documents

View all maturities of an issue and download the official statement and other documents available from EMMA for this issue. Click on a CUSIP number for security-specific data, including trade price data.

### Securities Details

<table>
<thead>
<tr>
<th>CUSIP</th>
<th>Maturity Date</th>
<th>Interest Rate (%)</th>
<th>Principal Amount At Issuance ($)</th>
<th>Initial Offering Price (%)</th>
<th>Initial Offering Yield (%)</th>
<th>Security Description</th>
<th>Current Fitch LT Rating</th>
<th>Current KBRA LT Rating</th>
<th>Current Moody's LT Rating</th>
<th>Current S&amp;P LT Rating</th>
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<td>09/01/2021</td>
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<td>50,030,000</td>
<td>120.234</td>
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</tbody>
</table>
The ABC’s of premium and discount bond prices

- A bond’s dollar price is the present value of its future cash flows.
- A bond’s yield is always quoted to the investor’s worst case scenario.
- As long as a bond is trading at a premium dollar price, the quoted yield will be to the first optional call date. Holding onto a premium coupon beyond the call date results in an instant increase in yield to worst, hence the nickname, “kicker bonds.”
- In a low interest rate environment demand for premium dollar price bonds rises, to defend against the possibility of a future rise in interest rates.
- The more rapid return of investment shortens the bond’s duration*, an attractive feature for investors seeking early return of principal for reinvestment and portfolio managers seeking total return strategies.
- For investors seeking to keep their principal intact, adding premium structure bonds requires the discipline of distinguishing amortized principal from interest income.

*Duration: “The weighted average term-to-maturity of the securities’ cash flows...the weights are the present values of each cash flow as a percent of the bond’s full price”

The Handbook of Fixed Income Securities, Frank J. Fabozzi, CFA®
Taxation of premium and discount bonds

• Premium bonds do not create a tax loss for an investor as long as they are held to maturity or called.

• The higher level of tax-free cash flows compensates the investor for the premium price paid on the bonds.

• This may be a source of confusion for investors because in the taxable bond market, premiums can be written off as losses against taxable income on the bond.

• Selling bonds prior to maturity may result in a tax event, a situation that is true be they premium, discount or par bonds.
Useful jargon

• Basis Point
  • Yields on bonds are usually quoted in terms of basis points, with one basis point equal to one one-hundredth of one percent
  • 0.50% = 50 basis points

• Day Count
  • Different kinds of bonds have different methods for counting the days between dates for purposes of calculating interest. This can be the actual number of days or a simplified way assuming twelve 30 day months
  • Fixed-rate municipal bonds use the 30 day month/360 day year convention

• MMD
  • Municipal Market Data service
  • A proprietary yield curve published daily by TM3 (Thompson Municipal Market Monitor)
  • “AAA MMD” is the benchmark for all tax-exempt pricings and represents an index of the highest quality municipal bonds
  • Municipal bond pricing (i.e., yields) is often presented in terms of a basis point spread to the “AAA MMD.”

• A security by any other name...
  • Bond: a security sold according to a State’s bond law
  • COP (certificate of participation): A bond-like security secured by a contract (a lease or installment purchase agreement), often used when an issuer wants to leverage its revenues but lacks legal authority to sell bonds
  • Note: typical term when referring to a security that matures in less than two years
Credit enhancement/bond insurance

• SIFMA*: 

Credit Enhancement: The use of the credit of a stronger entity to strengthen the credit of a weaker entity in a bond or note financing. This term is used in the context of bond insurance, bank facilities and government programs.

• Bond Insurance: Legal commitment by insurance company to make scheduled payment of interest and principal of a bond issue in the event that the issuer is unable to make those payments on time. The cost of insurance is usually paid by the issuer in case of a new issue of bonds, and the insurance is not purchased unless the cost is far more than offset by the lower interest rate that can be incurred by the use of the insurance. Individual investors cannot buy bond insurance [but they can buy insured bonds].

• MSRB**: 

Bond Insurance: A guarantee by a bond insurer of the payment of the principal of and interest on municipal bonds as they become due should the issuer or obligated person fail to make required payments. Bond insurance typically is acquired in conjunction with a new issue of municipal securities, although insurance also is available for outstanding bonds trading in the secondary market. In the case of insurance obtained at the time of issuance, the issuer of the policy typically is provided extensive rights under the bond contract to control remedies in the event of a default.
Questions

Past performance is no guarantee of future results.

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The municipal market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issuers of municipal securities. Interest rate increases can cause the price of a debt security to decrease. A portion of the dividends you receive may be subject to federal, state, or local income tax or may be subject to the federal alternative minimum tax. Although bonds generally present less short-term risk and volatility than stocks, bonds do contain interest rate risk (as interest rate rise, bond prices usually fall and vice versa) and the risk of default, or the risk that an issuer will be unable to make income or principal payments. Additionally, bonds and short-term investments entail greater inflation risk, or the risk that the return of an investment will not keep up with increases in the prices of goods and services, than stocks.

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