Commentary Coming disclosure issues with discount munis

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It's been a long time since bond reps at retail firms like Charles Schwab and Vanguard have had to worry about de minimis disclosure - the heads-up that buyers paying below the *de minimis* level will owe ordinary income taxes on their bond discount. That's because a long bull market has meant there weren't many discount bonds to trade. But as higher rates bring them back into play, the negative *de minimis* effect will also return. The difference this time is the availability of new analytics that correctly capture the downside risk. This materially raises the bar on discount-bond disclosure.

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Take a simple example. Say a rep is on a call with a client who wants income from a muni bond, but also wants to avoid the bigger price swings of longer maturities. So they limit their search to 10-year bonds, and end up identifying two candidates: one trading above par and another lower-coupon bond trading at a small discount, above its de minimis level.

The client decides to go with the higher-yielding discount bond, even after the rep alerts her that "Discount bonds can trade badly when things go south."

After a Fed tightening, the upset client calls in to complain that her 10-year discount bond dropped 40% more than the other bond she had considered. Up to now, most managers would feel justified in refusing to bust that trade, although it would still leave the firm with an unhappy client.

But what if the client complains differently: "I specified a 10-year bond instead of longer maturities to lower the price risk. However, an advisor friend of mine says that, according to a specialized app on Bloomberg, my bond has an effective duration of 14 years. I asked him what duration is and he said 'It's related to maturity, but it's a better measure of interest-rate risk. It's the standard professionals use.' In effect you sold me a longer-maturity bond when I wanted a 10-year one. That's not right…And why didn't you tell me about duration?"

That conversation wouldn't have happened before, because the proper analytics weren't available. But now that this specialized app can be found on Bloomberg, what will retail brokerage firms do? Although there's no mandated disclosure, firms may choose to get ahead of this by upgrading reps' skillsets and implementing new trading protocols. Otherwise they could find themselves in a terrible position: opposing reasonable customer complaints, not on the merits, but because no one is forcing them to do the right thing.

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