Non-rated municipal bonds represent a unique segment of the tax-exempt municipal bond market. There are tens of thousands of municipal bond issues that have never been rated, but the reasons for the absence of a credit rating vary. While many non-rated municipal bonds are from smaller, higher quality issues, there are many other non-rated bonds that represent riskier investments offering higher returns commensurate with their risk. Non-rated municipal bonds can be an excellent way for investors to earn higher tax-exempt income, if the risk/return profile of the bonds is appropriate for their investment objectives.

**CHARACTERISTICS OF NON-RATED BONDS**

**Absence of a Rating**

Municipalities generally issue bonds that are rated by a bond rating agency in an effort to reduce their borrowing costs. Strong credit ratings mean investors are taking less risk, so they receive a lower rate of interest on their bonds. Lower credit ratings indicate higher credit risk, and investors receive a higher rate of interest as compensation for assuming the risk. Non-rated municipal bonds are unique because they don’t appear on the credit rating scale. Municipalities have two main reasons for issuing bonds without a credit rating. First, some issues are of higher quality but the rating is foregone because the size or placement of the issue makes it uneconomical to pay for the rating. Second, many non-rated bonds would not meet the rating criteria of the rating agencies, or, if rated, would fall below investment grade (below triple-B).

Many non-rated municipal bonds are revenue bonds rather than general obligation bonds. Revenue bonds are backed by the income stream of the project the bonds finance, rather than the full faith and taxing power of the municipality. Projects commonly financed with non-rated revenue bonds include multifamily housing, nursing homes, hospitals, and private colleges. Understanding the project and the revenue stream backing the bonds are key factors to understanding the credit risk associated with the bonds.

**Liquidity**

Because most non-rated municipal bond issues are smaller in size and/or possess non-investment grade characteristics, there generally is less liquidity for these bonds than for rated bond issues. One reason for this is because investors in this type of bond often buy and hold, and do not try to sell the bonds before maturity, thus minimizing the market activity in these bonds. Smaller issues also mean fewer bonds to change hands between investors. Additionally, some non-rated issues may experience less liquidity because investors must be willing to take the time to learn the story and assess the risk before they are willing to invest.

**Story Bonds**

Non-rated municipal bonds are often referred to as “story bonds,” because the investor who knows the story behind the credit can make a better investment decision. Investors are often most familiar with stories on bonds issued in the communities where they live. For example, a strong local issuer may come to market with a small non-rated bond issue that represents good quality and value to the investor. Or perhaps a riskier issue with a more complicated story comes to market with a higher yield to attract investors. Whether the issue is local and familiar or not, the investor should review the official statement, which is the disclosure document designed to give investors all the information they need to make an informed decision about investing in the bonds. The sections in the official statement that describe the use of the proceeds of the bonds, the description of the project, the security for the bonds, and the discussion of the risks associated with the bonds are major components of the story.
POTENTIAL OPPORTUNITIES IN NON-RATED BONDS
Higher quality non-rated bonds are often priced to yield returns that are comparable to rated bonds. However, for riskier non-rated bonds, the reward for accepting the credit and liquidity risk is usually a higher yield. For those who can accept these risks, there are attractive opportunities to pick up additional yield on non-rated bonds over rated bonds. For example, a recent new issue ten-year non-rated revenue bond was priced to yield 5.62%, which is 200 basis points (2 percent) more than the average AAA-rated bond of the same maturity.

PIPER JAFFRAY EXPERTISE
With the vast array of non-rated municipal bonds in the market, there are excellent opportunities to enhance returns given adequate information and risk tolerance. Piper Jaffray serves as underwriter on dozens of non-rated municipal bond issues each year. Additionally, we are an active market maker in a wide range of non-rated bonds in the secondary market. Contact your financial advisor to discuss whether non-rated municipal bonds are a suitable addition to your portfolio.

Piper Jaffray does not provide legal or tax advice.