

The Yields of Lower Quality Municipals

The above analysis has been based entirely on the yields and yield prospects for long-term prime municipals. Most bonds, however, are rated less than prime and many are of distinctly secondary quality. Lower grade municipals naturally yield more than prime municipals of the same maturity. However, this quality differential is highly variable.

Table I in Appendix C reports the estimated yields for new issues of two quality groups of municipal bonds in all of the principal maturities. These quality groups are primes and so-called "good grades." These latter are, generally speaking, the best medium grade bonds. Table II in Appendix C lists the differentials between these two quality groups. It will be seen that, for the longest maturity, the primes have at times yielded 50 basis points less than the good grades, whereas recently this quality differential has come down to only 15 basis points. For the short maturities, the differential has been as wide as 30 basis points and as narrow as 5 basis points. Chart III on Page 22 shows the 30 year maturity quality differential over a period of years. It is apparent that the quality differential has declined almost steadily since 1957 and by 1965 it had almost vanished.

The decline in the quality differential is, no doubt, attributable largely to two factors: 1) Long years of prosperity have caused investors to forget the financial problems which many communities suffered in earlier times. After all for several decades the debt payment record of mediocre credits has been exactly as good as the debt payment record of prime credits. 2) During the past four or five years there has been intensive competition between institutional investors, mostly commercial banks, for maximum yield in order to offset the high cost of deposit money. This has led portfolio managers to accept progressively lower yield differentials in order to improve their current income performance.