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CHAPTER 4

The Marketing of New State and Local Government Issues

THE demand for funds by state and local governments, discussed in Chapter 2, is dominated by the complex problem of public capital expenditures. The supply of funds, discussed in Chapter 3, is dominated by the fluctuating attractiveness of high-grade, tax-exempt but rather low-yielding securities to institutional and individual investors. The institutions for marketing state and local government obligations supply the vehicle by which the disparate requirements of these two sides of the market are equated. This market is also the place in which the timing differences that inevitably arise between these factors are ironed out. This marketing system embraces both investment and commercial banks and includes very small as well as very large financial institutions.

The function of this chapter will be to provide a narrative picture of the marketing process and to present such quantitative data —unfortunately rather scattered—as bears on and measures the operations of this market.

MARKETING PROCESS

Once a state or local governmental unit has completed the necessary legal steps that authorize it to borrow money, the marketing process follows a fairly standardized pattern. If, as is usual, the issue is to be sold by competitive bidding,[1] the intention to borrow is announced formally (informal news has already been circulated in most cases) and bids are invited. In the somewhat rarer case of a negotiated offering, a consultant or an investment banking house is engaged as a financial adviser. If an investment banking house acts as the adviser, it may also organize the underwriting syndicate. This dual role, however, is frowned on by some critics. In the more common case of a competitive sale, the second phase is that of the organization of groups for the purpose of bidding on the issue.

[1] In the year 1957, 86 per cent of the public offerings were sold through public sealed bids, 12 per cent through negotiated sales, and 2 per cent were placed directly—largely with state and local government pension funds. *IBA Statistical Bulletin*, No. 6, January 1958, p. 8.

The third stage, which almost always follows hard upon the award of the bid to the group offering the lowest borrowing cost, is the reoffering of the securities by the successful bidders to ultimate investors.

The marketing of new state and local government issues is one of the principal lines of business of the big investment banking firms, and a few firms specialize in this business. This new issues market differs from the corporate one in that commercial banks are allowed to participate in it and are an important part of the market. The shares of individual firms in underwriting syndicates are not published, and so only general impressions of relative size can be presented. From some statistics relative to syndicate management presented later in this chapter, it would appear that commercial banks underwrite somewhat more than one-half of the dollar volume of new general credit obligations. Federal Reserve member commercial banks are barred from underwriting revenue obligations, however, and so the commercial bank share of the total market is probably about two-fifths. A dozen houses or banks that are recognized leaders, capable of managing great syndicates, probably account for about half the market in dollar terms. The next dozen account for about one-sixth of the market. More than 500 firms participate to some extent in underwriting and marketing new state and local government issues. Since investment banking, as an industry, has already been adequately described in the literature of finance,[2] the function of this chapter will be to deal with the special aspects of this system that relate uniquely to the marketing of state and local government obligations.

During the postwar decade, state and local government offerings became an increasingly important part of total investment banking business. This is true if measured in terms of the dollar volume of issues handled, even more so if measured in terms of gross revenue produced. The margins on state and local government security offerings, while less than those prevailing on equity security sales, are generally considerably larger than those received from the underwriting of corporate bond sales.

The mechanics of bidding for and reoffering state and local government securities have been so well developed that investment

[2] Such as *Fundamentals of Investment Banking*, Fennelly, McClure, and Clark, editors (Prentice-Hall, 1947). See particularly Section Two, Part III; Section Five; and Section Nine, Part I.

bankers can handle the issues of small as well as large governmental units quite economically. In practice, the smaller state and local governmental units seem to suffer almost no adverse effects because of their size.[3] The serial nature of the obligations, the fact that they often have complex coupon structures, and the diversity of markets complicate the marketing problem. The gross margin in state and local government underwriting needs to be larger to allow for greater marketing costs. Possibly the greater price variability which we study in greater detail in Chapter 6 is also a factor in these wider underwriting margins. Market strategy also differs; underwriting groups for an offering of state and local government issues usually are held together longer than is needed in the case of corporate marketings.

COMMERCIAL BANKS AS UNDERWRITERS OF STATE AND LOCAL GOVERNMENT OFFERINGS

The activities of commercial banks in underwriting state and local government security offerings explain one of the major differences between this market and that for other securities such as those of corporations. Since 1933 Federal Reserve member banks have been prohibited from participating in the underwriting of securities, except the general obligations of government bodies. This fact has special significance since the commercial banking system is the biggest single institutional investor in such obligations, and the trust departments operated by the bigger member banks control the buying of substantial amounts of these securities. Thus banks are important buyers as well as sellers of these securities. The number of banks having formal dealer departments is quite large, but those who are continuously active in this new issues market appear to number not much more than fifty institutions.[4] But many more than this number maintain some degree of interest in the market. A large number of the sales of small issues are to the local banker. The reports of sales of new issues in the *Bond Buyer* disclose innumerable cases of local issues going to a nearby bank.

[3] Frank E. Morris, Research Director for the Investment Bankers Association of America, reached much the same conclusion. He seemed to feel that the "equality of advantage" went down to even lower size groups than indicated here. "Size Characteristics of Municipal Bond Issues," *IBA Statistical Bulletin*, January 1957, No. 2.

[4] In October 1955, 57 commercial banks were listed in the *Blue List* directory of advertisers. A part of this group is relatively inactive except in local issues. About 20 banks appear to maintain continuous operations in the national market.

This type of business probably should not be considered as within the category of open capital market transactions but should be treated as a kind of parochial or local finance. Many bankers feel responsible for seeing to it that their local governmental units "get at least one decent bid."[5] But, apart from community pride and other noneconomic considerations, bankers have a binding customer relationship with the local governmental units. The deposits of local governmental units often can be employed profitably. The necessary condition for getting these deposits may be to support the market for the obligations of their governmental depositors. While no geographical distribution of bank-owned state and local government obligations is publicly available, the comments of examiners and others indicate that local holdings almost always predominate.[6] The fact that many commercial banks specialize in or limit their underwriting activities to the issues of local or nearby state and local governmental units should not be thought of as indicating any substantial quantitative restriction on such activities. The largest commercial bank in the United States, located in the state of California, limits its underwriting activities to the securities of that state or of local governmental units within that state. But within this limit this bank appears to do an excellent business and holds the largest commercial bank portfolio, which also means the largest institutional portfolio of state and local government securities in the United States.[7] At the other extreme, a large New York City bank which has been one of the most active managers of underwriting accounts itself holds only a small investment portfolio of these securities.

The presence of commercial banks in the groups that underwrite state and local government obligations gives some special marketing advantages to such groups. Commercial banks, being investors as well as underwriters, do not have to fret about the financing of their dealer inventories to the same extent that nonbank dealers do. Furthermore, the leading commercial bank in a buying group may

[5] In scanning the lists of sales of new issues in the *Bond Buyer*, our tabulators several times noticed cases of sales of local issues at interest rates which seemed to be lower than those prevailing in the central money and capital markets, particularly *in times of strain*.

[6] See Hengren speeches referred to in Chapter 3, note 14.

[7] "Obligations of States and Political Subdivisions Held by the 100 Largest Banks," *Bond Buyer*, February 4, 1956.

also "bank" or finance an underwriting deal if it must be kept together beyond the date of delivery of the bonds and therefore require such financing. As a result, banks may be rather firm holders and tend to work on the side of keeping groups together when these groups are not successful in selling out their offerings quickly. In other words, the presence of one or two large commercial banks adds to the fundamental underwriting strength of a group.

The great commercial banks have close ties with many potential customers: their own country correspondents, trust departments of related banks, wealthy individuals, and other financial institutions. The general knowledge by banks of who has money for investment probably gives them a rather substantial advantage in the marketing of state and local government obligations. On the other hand, the many facets of commercial-bank customer relationships probably make them unusually cautious as to the quality of securities they merchandise. They may be effective salesmen of the highest quality obligations; their zeal in selling intermediate grades is not quite as clear.

Commercial banks which are members of the Federal Reserve System would very much like to have the present statutes, which limit them to the underwriting of state and local government general obligations, liberalized. The volume of revenue financing is large and the profit margins are higher than those on general obligations. Commercial banks would like to have access to this new sector of the market. Commercial banks can invest in these obligations and $1,849 million of such securities were in insured commercial bank portfolios on June 30, 1956.[8] The effort of commercial banks to extend their underwriting privileges is, of course, bitterly opposed by the nonbank dealers and underwriters. With one important exception, commercial banks tend to mix with the nonbank dealers in the distribution of membership of bidding groups. The one exception is in the groups that bid for the bonds of the public housing authorities. The historical reason for a sharp bank-nonbank division in this one case seems to go back to the fact that nonbank dealers initially opposed banking participation in this market. Commercial banks finally won the right to underwrite

[8] *Assets, Liabilities, and Capital Accounts of all Insured Banks*, June 30, 1956, Call No. 45 (Federal Deposit Insurance Corp.).

PHA obligations, but this did not salve the injured feelings. A nonbank dealer group has clung together and has won most of the offerings. They have been opposed by a so-called "bank" group which is managed by a commercial bank and has a majority of commercial bank members but which also embraces some nonbank dealers.

STRUCTURE OF SYNDICATES

In most respects the groups organized to bid on state and local government new issues are similar to those organized for the wholesale buying of corporate issues. But moderate differences in practices exist. In the first place, management fees are rather uncommon in groups organized for state and local government bidding except in the case of housing issues and negotiated deals for revenue bonds. Management fees in this latter group are quite like those prevailing in groups buying corporate securities. The groups organized for state and local government bids have more regional character than is true of corporate groups. There is often, though not always, a better market for a state and local government issue in the territory of the issuing body; local investment banking houses and local commercial banks often have an insider's advantage in selling this market. Furthermore, it is probable that managers, in forming a group to bid on a state and local government issue, emphasize sales ability over underwriting strength rather more than would be the case in bidding on a corporate obligation.

Investment banking relationships have considerable historical continuity. The same names will be associated time after time in groups bidding on a specific issuers obligations. When the market is considered to be uncertain, buying groups lose some of their continuity. Weaker firms drop out if they do not care to assume the underwriting risks; stronger firms may drop out of accounts if they do not agree on pricing policies. They may reappear later—if they do not exercise their "drop-out" privilege too frequently or arbitrarily.[9]

Many evidences of institutional pride, of syndicate politics, and

[9] The resources of this project did not permit a study of the continuity of groups but that they have such continuity is evident from a reading of the offering advertisements. A specially interesting facet of such a study, if it were ever made, would be of the rise and fall of individual houses in the rankings involved in these listings.

of strategy similar to those that can be found in the syndicates organized for corporate offerings can be observed in state and local government buying groups. Many older and better known houses will not participate in a buying group unless it be as a "major" participant: i.e., with an allotment as large as that received by any other house in the group. Some houses will not participate unless their names appear high on the list of firms in the reoffering advertisements. At least one house sometimes prefers to have its name omitted from the offering advertisements when it is not a manager of the account or cannot secure the advertising position it prefers. It is customary to have the name of the manager of a buying group appear on the left-hand side of the first line of advertisement announcing the reoffering. But the holding of this position is sometimes juggled. Suppose a New York firm and a Chicago bank start as co-managers to form a buying group to bid on a forthcoming issue of a western state. Another firm with a strong sales position on the West Coast might be willing to join the group only if it were admitted as a co-manager. In such a case, the New York City advertisement might list the New York firm in the prized left-hand first line; the Chicago bank would take this place in advertisement appearing in Chicago; the third firm might have its name in the coveted position in a San Francisco advertisement. Advertising appearing in a magazine of national coverage, such as the *Bond Buyer*, probably would come closer to measuring which firm was the real leader in the group. Other matters of position in advertising sometimes are subject to acrimonious dispute.

MANAGEMENT OF THE SYNDICATES

Both the great investment banking houses and the commercial banks that are active in the national market for new municipal issues like to assume a role of management in the formation and operation of underwriting syndicates. Part of the reason is one of profit; in some syndicates, particularly those for revenue obligations, management fees are allowed in the syndicate arrangement. Even where there are no management fees, the manager is usually in a somewhat more strategic position to dictate terms and also to effect rapid distribution of the portion of liability assumed by his firm as an underwriter. Furthermore, the manager's role is one of considerable prestige. In the negotiation for formation of a syndicate, leading firms will sometimes refuse to participate unless allowed to come in as managers or co-managers.

The recently initiated tabulations of the Investment Bankers Association of America furnished our first quantitative clues as to the relative importance of various firms in managing syndicates. Table 17 shows the first 50 firms in the order of importance in the management of new issues during the year 1957. The accounts managed by these 50 firms accounted for almost four-fifths of the total public offerings of that year. This list of firms includes 16 commercial banks and 34 investment banking firms. As can be seen from the list, the great commercial banks tend to dominate the management of general obligations accounts. Only one investment banking firm is among the first five in importance in management of general obligation accounts, and only three such firms are in the list of the ten most important ones. However, since investment banking firms control the market for revenue obligations, the total dollar volume of accounts they manage slightly exceeds that of commercial banks.

A very high degree of specialization exists in the management role. Some houses or banks specialize in public housing authority obligations; some firms specialize in toll road bonds, still others in school obligations. Some firms have special competence for dealing with water and sewer revenue obligations; still others concentrate on school building authority bonds. Regional specialization is also evident. The third most important manager in 1957 was the Bank of America, which concentrates its activities almost wholly within the state of California. Naturally regional specialization is even greater in the smaller local accounts, not included in this tabulation.

BUYING STRATEGY

Once a syndicate has been organized for the purpose of bidding on a new issue, the determination of bidding strategy takes place in several steps: the determination of the probable price (yields) at which the various maturities of the issue can be sold (the "reoffering scale"); the selection of the gross margin or spread for which the group will work; the establishment of a coupon or a coupon structure that will "produce" enough gross revenue at the reoffering scale previously determined to cover the gross margin or

TABLE 17

Principal Managing Underwriters of New Municipal Issues, 1957

(in millions of dollars)

	General Obligation	*Revenue*	*Total*
Halsey Stuart & Co., Inc.	$367	$225	$592
First National City Bank of New York	435	....	435
Bank of America, N.T. & S.A.	360	....	360
Bankers Trust Company	326	....	326
Chase Manhattan Bank	300	....	300
Blyth & Co., Inc.	76	187	263
First Boston Corporation	80	174	254
Harris Trust & Savings Bank	228	....	228
Smith, Barney & Co.	48	162	210
Lehman Bros.	112	95	207
John Nuveen & Co.	56	117	173
First National Bank of Chicago	153	....	153
Northern Trust Company of Chicago	134	....	134
Harriman, Ripley & Co., Inc.	64	66	130
B. J. Van Ingen & Co., Inc.	34	94	127
Kidder, Peabody & Co.	81	27	108
Glore, Forgan & Co.	61	39	100
Eastman Dillon, Union Securities & Co.	30	59	88
Phelps, Fenn & Co.	72	13	85
Drexel & Co.	26	52	78
First of Michigan Corporation	52	22	74
Kuhn, Loeb & Co.	57	15	73
C. J. Devine & Co.	43	26	69
Marine Trust Co. of Western New York	66	....	66
Chemical Corn Exchange Bank	56	....	56
Ira Haupt & Co.	11	40	51
F. S. Smithers & Co.	8	39	46
Continental Illinois Bank & Trust Co.	46	....	46
Equitable Securities Corporation	25	17	42
Pierce, Carrison, Wulbern, Inc.	....	35	35
Guaranty Trust Co. of New York	34	....	34
J. P. Morgan & Co., Inc.	34	....	34
Salomon Bros. & Hutzler	20	13	32
Shields & Company	17	14	31
White, Weld & Co.	10	20	30
Merrill Lynch, Pierce, Fenner & Beane	19	8	27
Ohio Company	4	22	26
Ladenburg, Thalmann & Co.	....	26	26
American Trust Co., San Francisco	21	....	21

(continued on next page)

TABLE 17 (continued)

	General Obligation	Revenue	Total
Braun, Bosworth & Co., Inc.	$21	....	$21
Security-First National Bank of Los Angeles	19	....	19
Robinson-Humphrey Company, Inc.	a	$19	19
Butcher & Sherrerd	3	16	19
Philadelphia National Bank	17	....	17
Goldman, Sachs & Co.	7	10	16
First Southwest Company	10	5	14
J. M. Dain & Company, Inc.	13	....	13
Rauscher, Pierce & Co., Inc.	4	10	14
Sterne, Agee & Leach	9	4	13
First National Bank of Portland	12	....	12

a Less than half a million.

Based on issues of $500,000 or more. In co-managed issues the amount of the issue is divided equally among the co-managers, but each co-manager is credited with one issue with respect to the number of issues.

Source: IBA Statistical Bulletin, No. 6, January 1958, p. 9.

"spread" and still permit a bid of par or better for the issue being offered.[10] The first point is primarily one of market judgment but strategic considerations enter into the second and third points.

Experienced investment bankers develop considerable skill in judging the marketability of a given issue. Judgment of a given issue is based on two distinct types of factors: the quality or market appeal of that issue in relation to the general structure of yields, and the over-all interest rate or yield structure. The larger issues announced for sale usually have been or will then be appraised by the leading investment services and have rating grades assigned to them. This rating grade determines much of the market appeal of an issue. But the judgment of investment quality is considered to be considerably more refined than can be expressed in a single rating grade. Investment bankers know that issues of some areas and of some types have greater appeal to investors than is true of other issues. Investors' preferences may be illogical—indeed they often seem illogical,[11] but these preferences determine the shape of

10 See Appendix B. In the sale of some term bond issues and a few serial bonds, bids of less than par or of some small margin less than par are permitted, but the offering terms for most serial bond issues require a bid of par or better. In a few cases, the net price cannot be much in excess of par.

11 Which preferences are illogical and which are not may itself be seriously

the market; they are vital data that enter into the calculation of bidding prices. It is common for those organizing buying or bidding groups to canvass the market to determine the views of leading investors with respect to individual issues, as well as the funds that such investors have earmarked for purchases of tax-exempt securities.

The degree of informal pre-bid selling is hard to judge; the testimony on this point is conflicting. Some managers of bidding groups apparently try to have most of the real selling job done before a bid is submitted. Others apparently do not put on pressure until they have "bought bonds." But if any bonds with special or unique characteristics are planned, they are certainly sold pre-bid. Pre-formal offering selling of bonds acquired in negotiated deals is much more common; in fact, it is nearly universal.

Judgment of the general state of the market apart from the investor-appeal of a given issue is largely a judgment of relative interest rates and yields. If the value of a given issue relative to that of other tax-exempt securities has been determined—and investment bankers appear to have great skill in making such value judgments—then the problem is that of picking a series of yields that will sell bonds against the general state of the money and capital markets. Investment bankers also develop considerable skill at judging this aspect of the market. But mistakes are made and for a very good reason. The judgment of quality and knowledge of investor preferences and prejudices is not subject to short-term fluctuations. Experience of the past can be brought to bear on the marketing of any given governmental units securities now. But the money

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disputed. For example, all of the Public Housing Administration sponsored issues have the same basic credit foundation: the contractual assurance of debt service by the federal government. But the issues of some cities sell on a better basis than is true of other cities. And if the troubles potentially involved in actuating a guarantee are an onerous burden on investors these differentials may not be without some logic. Again, the fear of war damage seems to have made investors prefer the bonds of interior and particularly midwestern communities over the seaboard states and cities. Some towns seem to have an appeal to investors that cannot be explained on objective grounds of credit analysis. But it is still possible that these preferences are not without some foundation; in other words one man's logic may be another man's fallacy. For example, the bond issues of southern school districts have been severely penalized by the integration issue. In such a case it is hard to say just what is prejudice and what is canny investment logic. In any event, investor preferences are a fact investment bankers must face and a knowledge of these preferences is one of the prerequisites of a skillful buyer of municipal bonds.

and capital markets change and the pattern of change is not as predictable. This is essentially a judgment of interest rates or reoffering scales. A good reoffering scale not only should be at the right level; it should have the right slope. It should sell bonds equally well at all maturities. This is an extraordinarily difficult judgment and a certain number of mistakes is inevitable.

The reoffering scale is, as monetary economists will recognize, a kind of yield curve. It tends to follow the slope of other maturity-determined interest rate differentials. But, as we note in Chapter 6, the reofferings scales for state and local government securities often are not parallel to the other yield curves with which they would seem to be closely allied. Market strategy often seems to explain this lack of parallelism. As skilled judges of the market, the investment bankers, and particularly the great houses and banks that act as managers of the principal accounts, are very sensitive to the appeal of particular issues to various segments of the market. For example, a skilled account manager knows which issues will appeal primarily to fire and casualty insurance companies. These firms usually prefer the intermediate maturities. For such an issue the reoffering scale might be made a bit lower relatively in the intermediate maturities than at either the short or the long end of the scale. This effect might also be present, not just because a given issue was expected to appeal to fire and casualty buyers, but because this group seemed to "have money" and be in the market while other buyers were relatively less active. When the commercial banks were heavy buyers of tax-exempt securities in 1954, the lower end of the reoffering scales for state and local government obligations showed more slope than was true of the corporate maturity scale. In other words, since the market for tax-exempt securities is in some measure isolated from other sectors of the market, the slope of the reofferings scale is affected by market factors which do not operate in other sectors of the market.

Setting a coupon structure. Some of the invitations to bid specify that while the bidder may name the coupon, all maturities of the entire issue must bear this one coupon rate. When this is the case, the second part of the bidding procedure is merged with the third stage, indeed is dependent on it fully. The gross margin that the bidding group will "try for" is added to par and the lowest single coupon that will produce that amount of revenue at the agreed offering scale is attached. If the bidders are permitted to set coupons on the .05 or .10 percentage point intervals, then the margin above par can be kept low. If, however, the coupons must be named in quarters or eighths, then a rather more material margin may be required. Under these circumstances a bidding group may sometimes be faced with the choice of adopting a coupon just under the one that would have given them the margin they had initially planned on working for—and then of cutting this margin enough so as to post a par bid. This shaving of margins sometimes becomes the means by which winning bids are posted.

Usually invitations to bid permit bidders rather wide latitude in proposing coupon structures. When this is the case, the selection of a coupon system becomes a matter of considerable strategic importance.[12] The choice of coupon structure involves considerations of two sorts. As explained and demonstrated in detail in Appendix B, a coupon structure which is high in the short-term end and low in the long-term end will tend to show lower interest cost as computed by the traditional formula used in state and local government security sales. The method of computing interest cost used by municipal finance authorities has this result because the cost of a coupon paid on remote maturities has the same weight as a coupon paid next year. The mathematics of "present value" calculations, which underlie all conventional bond computations now employed in the securities markets, discounts the yield (or cost) of a remote coupon to "present value." Therefore, remote coupons have less weight than nearby ones. Under the "present value" conventions of computation no advantage would accrue to the use of "reverse slope" coupon patterns. For this reason, bidders have at least one good reason for shifting the high part of the coupon structure into the early years as much as possible. But the pattern of interest rates as a function of maturity has had a positive slope (has been "rising") for the past twenty-five years—just the opposite of

[12] Jerome Percus and Leon Quinto have demonstrated the nature of this advantage mathematically. "The Application of Linear Programming to Competitive Bond Bidding," *Econometrica*, October 1956, Vol. 24, No. 4, pp. 413-428. The severe limitation of assumptions imposed by the methods used left most of the strategic problems unexplained. The article also failed to recognize the difference between "present value" methods of interest computation and the traditional form prevailing in this bidding.

the coupon pattern preferred for cost-influencing computation. If the coupon structure and offering scale of an issue slope in opposite directions, the early maturities will sell at premiums, the later maturities at discounts.

This is not always good sales strategy. Many buyers, possibly a majority of them, prefer to purchase a bond at a price not too far from par. With the arithmetic of bond yields relatively simple, and bond yield tables widely available, it might be thought that this preference would make little difference. To some extent this is true of institutional investors. But it is not wholly true of them and hardly true at all of individuals.[13] We noted a few minor exceptions to this rule in Chapter 3 but securities which have a yield quite remote from coupon and therefore involving substantial premiums or discounts, often are hard to sell. The ability to market such "hard-to-sell" securities may be the reason why a group can afford to propose a bizarre but bid-winning coupon structure.

Dealers themselves used to prefer to hold high coupon bonds in their investment accounts since they were not until recently required to amortize premiums on securities held less than thirty days. For this reason there was an unusually active market in these bonds among dealers.

The importance of nonamortization of premiums to dealers is indicated by the considerable vigor with which they defended the practice when it came up for legislative revision. On July 9, 1957, the House Ways and Means Committee reported favorably on a Bill (H.R. 8381) to require dealers to amortize premiums on all tax-exempt bonds held by them. The IBA Municipal Securities Committee actively opposed this provision and went so far as to suggest alternatives which it claimed would close the "loophole." This committee also urged IBA members to make representations to their Congressmen that this provision would "cause an increase in financing cost in state and municipalities."[14] The report of the Committee referred to the fact that "dealers may trade premium bonds back and forth between themselves after holding the bonds slightly less than 30 days, so that they can report 'loss' on the bonds

[13] Trustees of a fund for which one person has a life interest and another is remainderman have good legal and accounting reasons for avoiding sizeable premiums or discounts.

[14] Report of IBA Municipal Securities Committee to the IBA convention in Hollywood, Florida, December 1957, as reported in the daily *Bond Buyer* of December 16, 1957.

as the premium disappears while receiving tax-exempt interest on the bonds. . . ."

High initial coupons have a long history; they have been used for at least two decades. But the low terminal coupon does not seem to have been used much before 1954 and 1955. In 1954 several issues of which the terminal maturities had coupons of 1 per cent appeared; in the fall of 1955 some bonds with the terminal maturities bearing one-fourth of 1 per cent were offered. In early 1956 this had been pushed just a bit further and at least two issues had terminal maturities bearing coupons of one-tenth of 1 per cent; one of these issues was for a forty-year maturity. The "present" value of a forty-year bond of $1,000 par with such a coupon to yield 3 per cent is slightly more than $350. In other words, a bidding group that can find buyers for oddly couponed obligations, and who are not obstructed by the lack of marketability that such peculiarities probably impart to a bond, have a special bidding advantage. Such specially couponed maturities probably have been placed before the bid is ever entered; the preselling of such special coupons therefore becomes a part of bidding strategy.

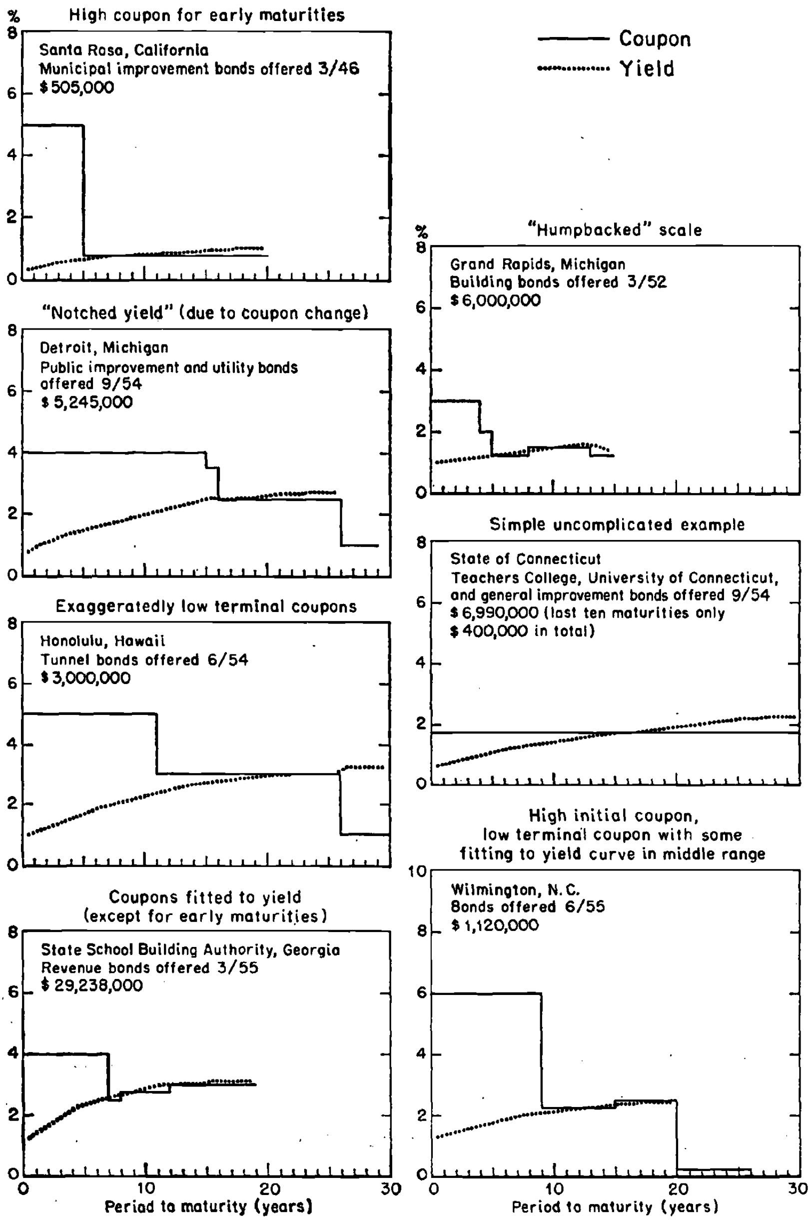
A canvass of a number of leading issues during the postwar period suggests that high initial coupons have been placed on about one-third of the new issues.[15] In most cases the high initial coupons were applied to the first five maturities, but the period was longer in some cases, shorter in others. On the basis of these two rather rough estimates, it can be guessed that about one-twentieth of outstanding state and local government debt consists of high coupon obligations, a sum now somewhat in excess of $2½ billion. The appeal of these bonds to selected buyers was discussed in Chapter 3.

The low coupons on terminal maturities, while novel, are still relatively rare and the portion of the outstanding debt represented by them is trivial. Yield concessions of from 35 to 70 basis points are needed to market abnormally low coupon bonds. Several interesting examples of split coupon structures are shown in Chart 6. The notations on each spell out the salient features there represented. The devising of special systems of coupons, however, has

[15] This was based on a tabulation of the 442 issues used in computing the quarterly yield series presented in Chapter 6. The proportion of issues with coupons on the early maturities which were in excess of the average coupon was slightly more than 33 per cent.

CHART 6

Selected Examples, Coupon Structure Relative to Reoffering Yield, State and Local Government Securities



come to occupy an unusually strategic role in the selection of winning bids, far more than the subject justifies on economic grounds since coupon structures represent, not real differences in the economic character of securities, but formal differences in the somewhat archaic system of interest computation employed by state and local governments in awarding the sales of their obligations.

Gross underwriting margins. Since agreement on the kind of offering scale that is salable is general, and since all of the bidding groups have equal access to the device of special coupons, the critical difference among bids often is the profit margin planned by the various bidding groups. Data which compare the proposed coupon structures and proposed reoffering scales of losers with bid winners are not available. We can only surmise about what would be found if such data were available. But it seems to be widely felt among the managers of underwriting accounts that the important difference among groups more often than not is the size of the gross underwriting margin. This, of course, is a choice which faces all merchandisers: whether to cut margin and speed up turnover or to keep a rigid "markup" policy at the possible expense of sales. The resources of our project did not permit us to study the point statistically but the impression grew as we studied the problem that there were real differences with respect to price policy among the leading syndicate managers. Some firms are volume traders; others work to keep their margins intact.

Since the problems of group organization should not increase relative to the sizes of groups, it might be expected that bidding groups would work for higher margins on small offerings. We were able to secure data only on a few (less than one hundred) winning deals, all of them handled by national houses. Thus smaller deals handled by regional houses could not be included in this tabulation. But among those for which figures were supplied, size appears to have little effect on the margins. These data are further limited in significance since they were mainly for deals completed in the fourth quarter of 1955. The margins on the ninety-one deals for which figures were supplied are shown in Table 18.

This array discloses no evidence that big issues get preferential treatment. Quite the contrary, it suggests, if anything, that the very small issues were handled for narrower margins. But a negative relationship seems as unreasonable as a positive one. Three of the

TABLE 18

Gross Margins on Reofferings of State and Local Government Securities Competitively Bought[a]

Size of Issue	*Average Margin per $1,000 Bond*[b]
Under $500,000	$10.86 (6)
500,000-1,000,000	10.38 (17)
1,000,000-2,000,000	12.71 (15)
2,000,000-5,000,000	10.92 (21)
5,000,000-10,000,000	10.78 (12)
10,000,000-20,000,000	13.84 (8)
20,000,000-50,000,000	12.28 (6)
50,000,000-100,000,000	13.50 (5)
100,000,000 and over	11.28 (1)
Average of all sizes	$11.61 (91)

[a] Selected accounts opened largely during the fourth quarter, 1955.
[b] Number of cases included in each average shown in parentheses.

cases which reduced the average margin shown on deals under $1 million were winning bids submitted by a single firm. All three were for unusually high-grade even if small issues. When a deal is within the underwriting and selling capacity of a single firm, it is possible that it may be handled with quite a small margin.

It appears that profit margins are much more influenced by the quality and average maturity of offerings than by size. This is suggested by a cross tabulation appearing in Table 19.[16] This table suggests that the quality of issue is perhaps the leading factor accounting for differences in margins. Average maturity also explains a part of the differences among margins but less than quality. Size, as already emphasized above, shows no sign of being a material determinant of the margin chosen.

Gross margins are, of course, what the underwriting groups *try* to achieve. If a reoffering fails to attract buyers and price cutting becomes necessary, then margins shrink, even vanish, and sometimes become negative. This is the cost of the pure underwriting function. The extent to which such price cutting reduces margins is un-

[16] The number of cases included in this tabulation is less than that shown in Table 17 because ratings (or the lack of a rating) could be verified for only a portion of the cases for which gross margins were supplied.

TABLE 19

Gross Margins on Reofferings of State and Local Government Securities Competitively Bought,[a] by Quality and Maturity

Average Margin per $1,000 Bond[b]

	MOODY'S RATING		
Average maturity	Aaa & Aa	A and Lower	Unrated
Less than 10 years	$8.22 (8)	$10.65 (11)	....
10 to 15 years	9.19 (10)	12.60 (10)	$14.33 (3)
Over 15 years	9.32 (4)	15.63 (6)	14.03 (3)

[a] Selected accounts opened largely during the fourth quarter, 1955.
[b] Number of cases included in each average shown in parentheses.

known. Since markets fluctuate, it must certainly be true that in some years the frequency of such price cuts is material and must affect underwriting profits materially. But in some periods these cuts are far less common—but hardly ever absent. Even in the strongest of markets, bidding groups every now and then over-stretch themselves and must use the ancient weapon of price to move their merchandise.

The data on margins which were collected covered only a brief period late in 1955; it is quite likely that in other periods margins might change in response to competitive and market conditions. For example, it appears to have been the case that the gross margins built into underwriting deals in the early years of the postwar decades were somewhat less than those put on deals in the later years. During that period offerings were scarce, sales were easy and groups were anxious buyers. Later this situation changed. During the stiffer money markets of 1956, the margins on deals widened by one to three dollars a bond; a kind of risk premium against the hazards of a market that was thought to be uncertain and even dangerous. During December 1956 the margins became particularly wide. While dealers were suffering heavy inventory losses, they were often making unusually good margins on the new deals that were well accepted. This pairing of unusual losses and gains is what brings out the highest order of strategy and courage in the investment banking community.

The margin between bids. The margins separating sealed public bids reflect both the precision of judgment involved and, to some extent, the character of bidding strategy. Many winning bids are relatively close to the second highest bids; these cases tend to be publicized. To the extent this circumstance is representative of bidding generally, it can be taken as evidence of the skill of investment bankers in judging the state of the market, assuming, of course, that collusive practices are not followed. In our inquiry we have found no evidence of such practices.

The repeated experience of the syndicates in preparing bids gives them the foundation for remarkable accuracy in bidding strategy. The process of organizing a group and preparing a bid are time-consuming and expensive enough so that few groups enter into the bidding competition unless fairly serious about wanting to buy bonds. While each group wishes to submit a winning bid, no group wants to be caught submitting one that is separated from the second bid by much of a margin. Apart from the hazards of paying too much, this margin is carefully noted by sophisticated investors and is likely to hurt the salability of an issue. Investors argue that since the bid winners paid an appreciable amount more for the issue than was offered by the second highest and other bidders, this is evidence of overpaying so that the reoffering is no bargain.[17]

The closeness of the bids, figured in terms of interest cost as it is computed in most state and local government sealed bidding sales,[18] may be deceiving; bids are calculated to minimize this cost. When bidders are permitted to name their own coupon structure, net interest cost is about the only form of comparison that can be used but it is a deceiving basis of comparison, as Appendix B shows. On sales where only a single coupon can be named, the comparison of bids is valid. When only one coupon rate can be named for an entire issue, variation among bidders would usually be covered by a range of about one-quarter of a per cent or less though this range is sometimes exceeded. The winning and second best bid

[17] This fact seems to open up the possible use of game strategy by bidding groups. In a tight and uncertain market in which only two groups are competing for an issue (and on larger issues the number of groups being formed is widely known in the "street") one group might prefer to submit a quite low bid on the general theory that at such a price they would be glad to buy the bonds. If the "winning" group pays appreciably more, the low bid of the "losing" group will embarrass the winning group in the reoffering sale. This would be the strategy of the "let-up" pitch.

[18] See Appendix B.

will often be for the same coupon with the only difference being in the amount of premium offered.[19]

The margins that separate bids can easily be minimized by looking only at the dramatic cases. About half of the time the margin between the winning bid and the second best bid is less than one dollar a bond. A close pair of bids may be separated by less than 25 cents a bond, and sometimes the margin is in pennies. But quite often the margin is not only greater than one dollar; it may be materially more. Every so often the winners' margin in a large and well-publicized sale will considerably exceed the space that separates the second from the third bids, and so on. In fact, the range of prices found in the full scale of bids is often material. While the range is usually less than ten dollars a bond, sometimes it is rather more. In the sale of big issues when the number of bidding groups is small—probably not more than two groups in the case of very big issues—the margin between the first and second bid is also the full range of prices. Such margins tend to be rather small. But an intermediate sized issue may bring out quite a few bids covering a considerable range. In the sale of very small issues, the margins between bids are often much higher. If such an issue attracts only a couple of bidders, the margin between bids may easily be from ten to twenty dollars a bond.

NATIONAL VERSUS LOCAL SYNDICATES

Larger state and local government issues are generally marketed by national syndicates, that is, syndicates managed by firms operating throughout the country and including a geographically distributed membership. Smaller issues, however, tend to be marketed either by local syndicates or occasionally by a single, sizable underwriter. There is no exact margin of size at which issues become too small to attract national interest and therefore come to attract bids only from local syndicates. One study of the underwriting of southern municipals suggest that virtually all issues of $250,000 or less were locally underwritten. Those over $1,000,000, on the other

[19] Because an arithmetically valid direct comparison is not possible we prepared only a few tentative and approximate tabulations comparing winning and other bids. The observations in the following paragraph are based on these fragments.

hand, were quite generally handled by national syndicates. The point of uncertainty was from $250,000 to $1,000,000.[20]

This study also suggested that local syndicates were more likely to handle either unrated issues or those of very high credit rating. Those of intermediate credit ratings, if of adequate size, tended to be handled by national syndicates. This study also pointed out that a national syndicate would usually include several firms located in the area of the issuing authority, presumably because of their strategic position for selling the obligations.

No evidence was uncovered as to whether the activity of local syndicates varied between areas of the country. On the West Coast leading banks often organize syndicates for securities originating in their area. These syndicates, though dominated by local houses, often should be treated as being definitely national in status. On the other hand, very high quality New England issues are often purchased by a single large firm. In other words, there is some evidence of regional diversity in the handling of the smaller and intermediate-size issues, though not a clear enough difference to furnish a foundation for further generalization.

SELLING STRATEGY OF SYNDICATES

When a syndicate is organized, it may be made an undivided account (sales efforts are pooled) or a divided account (each member is responsible for his share of sales). By reserving some bonds for syndicate account, some accounts are of a mixed nature. The issue is sometimes a cause of friction between syndicate managers and members. The sales efforts of members depend, to some extent, on the type of account of which they are a member.

The cherished hope of every syndicate manager is that when he has been successful in buying bonds, he will be able to resell them promptly at the scale agreed upon initially. Immediately after learning of winning a bid, the manager and other account members will put on a vigorous drive to sell an issue as quickly as possible; they like to have an issue "go out of the window." The mechanics of telephone selling involves strenuous and active work for the first few hours. If such a success is attained, the affairs of the syndicate

20 "Southern versus Non-Southern Underwriting of Municipals," by Charles T. Taylor, *Southern Economic Journal*, October 1957, Vol. XXIV, No. 2.

may be completed quickly and the accounts settled and reported back to the members by the manager.

If, however, an offering does not meet with such striking success and some bonds remain unsold after the initial effort, a number of strategic decisions must be made. If it is felt that the market itself has changed between the time of entering the bid and the moment of selling, it may be argued that prices should be cut immediately to bring the issue into line with other obligations. This, however, is generally not done for some period. A syndicate would be thought guilty of remarkably bad judgment if it cuts prices quickly. By and large, syndicate managers are more likely to favor retaining initial offering prices than the smaller members who have a somewhat more nervous and uncertain attitude and may be readier to cut prices. Indeed, one of the functions of the syndicate manager of a divided liability account is to police the reoffering and to make sure that members are not covertly cutting prices in order to sell their portion of a slow issue.

The syndicate contract normally runs for 30 days but is usually subject to renewal. Accounts are frequently held together for somewhat longer periods, but at some stage after 60 days a possibility of closing out the account and distributing the unsold bonds to the members is seriously considered. Once an account has been broken up and the obligations distributed to members, each one is at liberty to follow such price or holding policies his judgment dictates or his financial position permits.

The roles of individual investment banking firms and of individual commercial banks differ greatly in a syndicate. Some firms have "good distribution" (a large or effective sales organization) but they do not have the capital to act as major underwriters. Other firms stand in the opposite position of having ample capital to take underwriting risks but of having somewhat less broad distributive outlets. Still other firms may have the kind of aggressive executives that make them natural managers; others may lack such talent and leadership. Such specialization weighs in the formation of a syndicate.

Concessions to dealers. As is customary in the reoffering of securities, the syndicates generally make "concessions" to any dealer who is a member of the National Association of Security Dealers. These concessions can be viewed as a kind of sales commission although they permit dealers to buy such securities for their own account at a price a bit below the offering price. It is also customary, although not universal, to allow slightly larger concessions to account members than to other dealers.

Because state and local government securities are usually offered in serial form, the concessions often take on a somewhat complex pattern, the usual variation being that the shorter maturities are given the lower concessions. The greater sales effort is usually thought necessary for the longer maturities, so larger concessions are given for the long maturities. But circumstances vary; in some markets the middle maturities seem to be harder to move and they are given the larger concessions. The pattern of concessions is also influenced by the quality of securities; the higher-grade securities are thought easier to sell and are given somewhat smaller concessions. A distribution of concessions based on late 1955 data is shown in Table 20. This table was based on observations for only one month; it does not reflect the fact agreed to by most observers that concessions vary according to the state of the market,

TABLE 20

Concessions Made to Members of the National Association of Security Dealers by Syndicates Reoffering State and Local Government Securities, December 1955

	SECURITIES RATED[a] (CONCESSIONS QUOTED AS FRACTION OF ONE PERCENTAGE POINT)							
	Aaa and Aa				*A or Lower*			
	1/8	1/4	3/8	1/2	1/8	1/4	3/8	1/2[b]
First 3 maturities	33	16	1	..	13	30	2	4
4th to 5th maturities	9	26	4	1	..	30	6	7
6th to 10th maturities	..	78	12	10	..	33	49	20
11th to 20th maturities	..	65	89	31	..	20	56	119
21st to later maturities	..	9	16	6	..	..	10	38

[a] Based on either Moody's or Standard Statistics ratings.
[b] Includes a very few cases of concessions of a 3/4th.

Source: Reports of reofferings of leading municipal issues in the month of December 1955 as reported in the *Investment Dealers' Digest.* Since each maturity was treated as a separate issue, the totals in the table above are individual maturities, not of offerings.

small when sales are easy and larger when money and capital markets are tighter.

Since the concessions to members of syndicates for "taking down" securities are not published, we did not have access to any reliable record of these amounts. It is reported, however, that members' concessions are often larger by about one-eighth or one-fourth at each maturity except for the very short ones. If part of an issue is not reoffered, there is, of course, no concession since there is no outside sale of such a portion.

In the case of revenue obligations, which are more often in term (single maturity) rather than serial form, the concessions seem to be roughly equal to or slightly larger than those allowed on the sale of term corporate obligations. The margins on the sale of negotiated issues, particularly for turnpikes not yet constructed, have generally been at least two points (or $20 a bond) and sometimes almost twice this amount. Such an amount is materially higher than the margin for corporate underwriting. Concessions on deals of this sort have usually been somewhat larger than shown in Table 20, at least three-fourths of a point.

Concessions may be crudely estimated to account for about one-third of the gross margin on state and local government reofferings, sometimes more. This runs fairly parallel to the concession fraction prevailing in the case of public offerings of corporate bonds.

Divided and undivided accounts. The rather strong feelings of investment bankers with respect to the choice between divided and undivided liability is not related to the issue that might be indicated by these words. The financial strength of underwriters is generally such that the financially strong members of a syndicate are not usually worried about the ability of the others to perform their ultimate underwriting functions. The issue is rather one of the way in which the members discharge their liability to each other. In the case of an undivided liability with a large lot of the securities assigned for syndicate selling, the sales effort of each member is, in effect, a sales effort for the entire syndicate. A member continues to be "liable" for unsold obligations no matter what his own sale success may have been. With divided liability a member may discharge his liability by selling a proportion of obligations equivalent to his participation. In other words those syndicate members with good distributive outlets and strong sales forces much prefer divided liability. Firms with large underwriting strength in the form of capital, but with weaker distribution, prefer undivided liability.

Because of record-keeping problems, serial issues are more likely to be handled as undivided accounts, term bonds as divided accounts. In weak markets, some firms will stay in a divided account whereas they would withdraw from an undivided account because of confidence that they can be more successful in selling the bonds involved than other members of such an account.

INVENTORY POLICIES OF UNDERWRITERS

This market is quite delicately poised. While it is often in a state of equilibrium, it is usually an unstable equilibrium at best. Like a block poised on one end, it can be upset with relative ease. Profit margins relative to potential losses are small; sharp price movements produce sizable inventory losses or profits. Because of the fixed offering price in the new issues market, dealers hold to the suspicion that losses are more likely than profits and that the profits on ordinary business must be fairly good to offset the inevitable losses on some deals.

Capital margins in the securities business are thin; inventories may be rather large relative to capital. As a matter of business policy, many of the firms participating in the underwriting of state and local government issues do not have enough capital to justify the taking of what seem like very good risks. For example: suppose a given "deal" turns slow for reasons that everyone believes to be temporary. A firm with considerable capital may be justified in holding the securities involved in the deal until the expected recovery in the market takes place. But a smaller firm might, for very good strategic reasons, find it unwise to follow such a policy. Even if the chances of early recovery are excellent, the risks of the alternative are excessive. If the "deal" stays frozen, the small firm with little capital cannot enter new deals; it becomes stuck with no merchandise to sell except some securities on which it cannot cut price. Its sales force may become rusty or lost to other firms who are still active. Thus, small firms with little capital are disposed to close out and take their losses early. Large firms, particularly the leaders of groups, do not like to acquire the reputation of having managed slow deals that are broken up or on which losses are taken.

They want—if their capital permits—to hold out. Pride as much as profits often seems to account for this attitude.

The considerations that lie back of these judgments have the flavor of strategy much more than of traditional economic analysis. Many times the decision of an offering group as to whether to hold together or break up depends on the amount of free and uninvested funds available. The great institutional investors use a standard excuse if they wish to back away from a deal: they can claim to be "out of money." By this they mean that they have committed all of their investment funds; none are free. But the accounting measurement of this point seems to be ambiguous; institutional practices vary. Investors who claim to be "out of money" seem to be able to find money when the bargains get sufficiently attractive.

Any one investor can be fairly confident that if enough investors back away from the market, it will "come their way." Yields will improve and prices will go down. So the strategy of investors may be that of backing away from current offerings even though they are of the investment quality they prefer. Their funds can temporarily be invested in short-term form. The cost of holding off depends on the level of short-term interest rates. When short-term interest rates are low, investors suffer a material loss if they hold funds not fully invested at the full term their investment policy permits. Any short-term gains they may make on possible changes in the market in their favor may be lost in reduced interest income. Investment bankers, able to borrow at much less than the accruing coupons on their inventory, make a profit on their "carry," and so may be in no great hurry to sell, particularly if the visible supply of new issues forthcoming in the future periods is sparse and uncertain.

On the other hand, when short-term rates are high and close to, or even possibly above, long-term interest rates, investors can employ their money in short-term form without much loss of income, with sometimes even a little gain. At the same time, investment bankers, to the extent they use borrowed money, make no profit on carrying an inventory of unsold securities; indeed they suffer the unmeasurable losses of hobbling or inability to take on new business. If the volume of new business "visible" in the future[21]

[21] Visible supply has a number of technical definitions in the securities markets. In the municipal bond market the statistical practice of the *Bond Buyer* is to treat specifically announced competitive offerings falling within the next

should be large, the incentives for closing out of accounts is particularly high.

This delicately poised nature of the municipal bond market accounts for conditions that are sometimes described by such drastic terms as panic or near-panic. An examination of the periods described as "panics" indicates that they were those in which the structure of the market broke down; dealings became impossible and the market suffered from a kind of freezing. Drastic price declines can take place without panic if a market still exists and if buyers and sellers stand ready to do business at some price. Practical market analysts sometimes measure this by the time continuity of price quotation changes. For example, the organized stock exchanges, the New York Stock Exchange in particular, place great emphasis on the continuity of quotations. They charge the specialist with the function of "making markets," which amounts to furnishing such a time continuity of prices and transactions. Considerable discontinuities in price would not violate the economist's ideas of markets if rational interpretation of prevailing circumstances accounts for the discontinuities. But under conditions of panic a large majority of those who can, withdraw from the market either as buyers or sellers. Then those under external pressure to find a market at any price may find that no market exists; no buyers will give firm bids for any appreciable volume. Panic is really a paralysis of the market function. Withdrawal from the market accounts for such paralysis; yet this withdrawal may be prompted by quite rational behavior on the part of the principal participants.[22]

EFFECTS OF SIZE OF ISSUE ON MARKETABILITY

One of the commonest criticisms of the investment banking system as it now operates in the United States is that, while offering excellent service to the giant corporations, it fails to meet the financial needs of smaller-sized businesses. This criticism could not

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thirty days as being a part of the visible supply. Negotiated financings are not included in the *Bond Buyer* visible supply. On the other hand, the *Investment Dealers Digest* treats any definitely announced corporate offering of debt securities as being a part of the visible supply, no matter how far off in the future.

[22] Since we do not have an economics of the individual financial firm, this point cannot be pursued very far. Common observation suggests that competition of the sort that narrows profit margins hastens the withdrawal incentives and so renders a supposedly competitive market more subject to panic than a more administered market.

be leveled at the investment banking support of smaller local governmental financing. Indeed, one of the more significant findings of this survey is that moderate sized local governmental units seem to fare quite well in the new issues market, often better than the big cities. Small state offerings often seem to fare better than those of the big states that come to the capital markets more often. Tiny local governmental units probably pay modestly higher rates than middle-sized cities of comparable credit rating, but it would be hard to support the charge that they are much penalized for their small size. Indeed, a small local governmental unit which maintains a strong credit position probably can borrow without more than a nominal discount for size.

Just how relevant this analogy is to business finance may be argued. Small business may suffer from its size as well as its credit weakness in securing access to the long-term capital markets. But if the credit standing of small business were generally as good relatively as the credit standing of small state and local government units, is it not possible that the machinery of investment banking would soon emerge to give such small business access to long-term credit on terms relatively as good as those enjoyed by smaller local government units? The point is worth reflection.

Big state and local government offerings equal the largest of corporate offerings. But at the other extreme, a large number of relatively small issues are offered on the market. The (arithmetic) average size of the long-term state and local government offerings which was reaching the pages of the *Bond Buyer* in the first half of 1956 was just a little more than $1 million. Unadvertised issues doubtless were much smaller in size. In the early years of the decade this average was only a little more than half as great. The arithmetic averages doubtless conceal considerable distributional skewness. Roughly four-fifths of new offerings are in issues of under $1 million. The median size of offering tabulated by the research department of the Investment Bankers Association for the first half of 1956 was about a quarter of a million dollars.[23]

Very small issues are typically bid for and bought by a single buyer rather than by a formally organized bidding group. As Table 21 shows, about two-thirds of the issues under half a million dollars reported in the *Bond Buyer* for the month of December 1955 were

[23] Letter from Frank Morris, Director of Research for the IBA.

TABLE 21

Winning Bidding Groups for Public Offerings of State and Local Government Securities, December 1955

No. of Firms in Group Winning Bid	*Size of Offering (in thousands of dollars)* Under 200	200-500	500-1,000	1,000-2,000	2,000-5,000	5,000-10,000	10,000-20,000	20,000-50,000	50,000-100,000	100,000 & over	*No. of Winning Bids*
1	174	61	14	4							253
2 or 3	31	48	22	5	1						107
4 to 7	1	15	26	20	7	3					72
8 to 14		1		4	15	2					22
15 to 29				2	3	1		1			7
30 to 59					1	2	4	2			9
60 to 99							1				1
100 and over								1[a]	1[b]		2
Total offerings	206	125	62	35	27	8	5	4	1	none	473

[a] The winning bid for a California toll bridge issue of $46 million was submitted by a group of 183 firms.

[b] A New York State thruway issue of $50 million was won by a group of 165 firms.

Source: Based on all usable reports in the section "Municipal Bond Sales in Detail" in the five weekly issues of the *Bond Buyer* for December 1955. Canadian issues are excluded.

awarded to single bidders. If the even smaller issues that elude reporting were included, the proportion would doubtless have been still larger. As this table also shows, the industry of investment banking seems to adapt itself to the formation of a great number of small accounts readily. The participation of commercial banks, essentially local institutions by nature, and of the smaller investment banking houses undoubtedly contributes to this result.

An interesting conclusion may be drawn from this table. The relatively small number of bonds for each member in these buying groups suggests considerable spreading of the risk. In a majority of these groups the average number of bonds per member is from 200 to 500. The underwriting of state and local government obligations is not regulated so the sizes of participation of "major" and other members of buying groups are not published. The participation of even major members, however, is bound to be relatively small when compared with the allotments in corporate bond buying accounts.

The gearing of the investment banking machinery for handling modest-sized state and local government offerings as well as the giant ones can be shown in still another way: the number of bids attracted by offerings of various sizes. If the number of bids attracted by offerings of moderate size is adequate to insure competitive vigor, it can be presumed that governmental units borrowing in such amounts do not suffer from discrimination in the capital markets. A tabulation of the number of bids attracted by offering of various sizes is shown in Table 22.[24]

As this table shows, the very small and the very large issues attract fewer bids than intermediate sized issues. This tabulation does not prove the presence of active bidding for the very small issues, nor does it prove the absence of such bidding. Very small state and

[24] One defect in this table, described in a note to it, should be emphasized so as to avoid misunderstanding. This table was based on the reports of completed sales published in the five weekly issues of the *Bond Buyer* for December 1955. While the editors make great efforts to get complete reports, the number of bidders cannot always be determined from the official reports submitted to the *Bond Buyer.* Furthermore, there is a reasonable suspicion that when an award of sale is made to the sole bidder for an issue, this fact may be obscured in the official report for reasons of pride and otherwise. The tabulation shown in Table 22 includes only those cases in which it seemed reasonably clear that all of most of the bids submitted were reported. But the chance of error and bias in this tabulation should not be minimized.

TABLE 22

Number of Bids in Relation to Size of Public Offerings of State and Local Government Securities, December 1955

	Size of Offering (in thousands of dollars)										
No. of Bids	*Under 200*	*200-500*	*500-1,000*	*1,000-2,000*	*2,000-5,000*	*5,000-10,000*	*10,000-20,000*	*20,000-50,000*	*50,000-100,000*	*100,000 & over*	*Total*
1	11			1							12
2	4	6	4	7	1		1		2		25
3	20	14	11	9	8	2	3	2			69
4	9	7	7	5	5	3					36
5	7	5	2	3	1	1					19
6	2	2	2	3		1	1				11
7		2	2		1						5
8			2		1						3
9		1									1
10		1									1
11					1						1
12				3	2						5
13											
14					1						1
Total offerings Tabulated	53	38	30	31	21	7	5	2	2	none	189

Cases in which a single other bidder was named, introduced by the phrase, "Second highest bidder was . . ." have been omitted from this tabulation. However, lists of unsuccessful bidders headed, "Among the other bidders was (were) . . ." have been included. Since many lists contained two "also-ran" bids (and additional bidders were not excluded by the heading), it is possible that, due to some custom of listing adopted to save time or space, the modal number of bids at three in so many cases is spurious. Canadian issues were also omitted.

Source: Based on all usable reports in the section "Municipal Bond Sales in Detail" in the five weekly issues of the *Bond Buyer* for December 1955.

local government units may find it difficult to attract a great deal of interest to their issues. But no such difficulty exists for intermediate sized issues. Issues of half a million dollars or more attract an ample number of bids. And, as we noted above, small issues do not seem to have a marketing cost higher than that found in larger-sized offerings. Though not shown by this table, it is doubtless true that the sales attracting quite a large number of bids are of moderate-sized but high-quality issues. In other words, there is a kind of "U-shaped" character to the distribution of the number of bids.[25] Very large sales will attract only a few bids because it is not practical to organize a large number of accounts. Small sales tend to attract only a few local bids. But intermediate-sized issues attract a substantial number of bids.

It seems fairly evident that this circumstance works to the advantage of moderate-sized local government units which maintain a highly regarded financial standing. They attract many bidders and probably get the advantage of low interest costs as a result. Chapter 6 develops the point that the yields on these moderate-sized issues often appear to be better than on the very large issues. Part of this superiority in the borrowing ability of these intermediate sized units is doubtless due to the fact that investors often search for such names in the process of getting area diversification. But the number of bidders must also be a substantial factor in achieving such excellent results. In the offering of very large issues the organization of only a few groups, often only two, is feasible. When only two groups are competing, they can appraise rather closely the bidding strategy of the other side; the analytical apparatus of duopoly applies. The influence of "strategic restraint" comes to bear, and pricing does not "get out of line." But when a larger number of smaller groups are bidding on a moderate-sized issue, the appraisal of strategy by opposing bidders cannot be as precise. In these cases each bidding group cannot be aware of the existence of all other bidding groups and of their composition. A "dark horse" group may easily emerge to win the bid.[26] Bids can "get out of line."

[25] Also noted by McClintock (Harriman, Ripley & Co.), in Part 1, Section 9, page 9, of the 1946 loose-leaf edition of *Fundamentals of Investment Banking* cited in note 1 of this chapter.

[26] This suggests still one more way in which game theory may have relevance to this market. When there are only two groups, the problems of strategy can be reduced to two-party, non-zero-sum game form. The circumstances in which

THE EFFECTS OF COMPETITIVE BIDDING ON THE MARKETING OF NEW STATE AND LOCAL GOVERNMENT ISSUES

Most state and local government issues are sold by sealed public bidding. The predominance of this with respect to general obligations is shown in Table 23. This also shows that negotiated sales,

TABLE 23

Method of Offering Municipal Bond Issues, 1957
(par value in millions of dollars)

Type of Offering	*General Obligation (amount)*	*(per cent)*	*Revenue (amount)*	*(per cent)*	*Total (amount)*	*(per cent)*
Public sealed bidding	$4,519	94.4	$1,323	65.3	$5,842	85.8
Negotiated sales	195	4.1	638	31.5	833	12.2
Private placements	71	1.5	65	3.2	136	2.0
Totals	$4,785	100.0	$2,026	100.0	$6,811	100.0

Federal government loans are excluded.
Source: IBA Statistical Bulletin, No. 6, January 8, 1958, p. 8.

though relatively more important in the case of revenue obligations, are still less frequent than competitive sales.

Competitive bidding unquestionably narrows the gross margin earned by investment bankers; there seems to be no doubt of that fact. But the procedure may be clumsy, and dating of the sale far in advance reduces the maneuverability of the borrower. A negotiated offering may be put before the market quickly when conditions appear favorable; the investment bankers' greater margin may be far more than saved in a lower interest cost to the borrower—if truly superior timing thus becomes possible. But the validity of this assumption is not proved. Perhaps the borrowers connected with investment bankers of superior judgment would benefit from superior timing, but can this be true of everyone? If a given volume of state and local government securities is to be marketed over the long run, can every borrower benefit from superior timing? If the answer to this last question is affirmative, it begins to sound as if investors suffered net lower returns from securities marketed through

larger numbers participate, however, can only be dealt with descriptively and without the more formal and rigorous apparatus.

negotiation rather than by means of competitive bidding. But this certainly does not seem to be the testimony of investors; indeed, some of them regard competitive bidding as a way of persuading investment bankers to pay too much for securities. But if this latter view is true, then it again appears that competitive bidding may have some advantages for the borrowers as over against lenders.

A more sophisticated view might be that in periods of moderate capital demand with high security prices and low yields, competitive bidding probably favors borrowers and trims the yields available to investors. But in a tight money market with high capital demand and a barely adequate flow of saving, then competitive bidding exposes the borrower to some marketing hazards. Even in such periods, the *average* cost to borrowers may be just as low with competitive bidding as with negotiation, but some borrowers then fare worse than would be true with negotiation and some fare better.

At least one contrast seems to be valid: the existence of competitive bidding does not lend itself very well to the kind of continuing secondary market that most borrowers like to see prevail for their securities. A small governmental unit comes to the market rarely and its occasional offerings are absorbed by investors without leaving much of a trace. If a few of these securities reappear in the secondary market, the turnover cost is high, but again they leave little trace in the market. But a large governmental unit that must face the market time after time, possibly with only moderate intervals between financing operations, has to worry about the supply of its securities in the secondary market. If an appreciable volume of its securities drift back into the secondary market, the prices needed to move these securities may tend to be low and to blight the chances of getting a good price on its next offering. Indeed, such a governmental unit may find it advantageous to maintain a kind of supporting operation so as to maintain a good price record for its outstanding securities.

If such a governmental unit has a negotiated and continuing relationship with a single investment banker, it is entirely possible that the trading department of this investment banker may be able to keep a healthier tone in the secondary market for the unit's securities than would be true if it was financed by means of competitive offerings. The winner of a bid will undertake to market the bonds he has "won," but he can hardly be expected to maintain a continuing interest in the market for the obligations of this issuing governmental unit.

The existence of competitive bidding does not mean that investment bankers fail to have a continuing interest in the financial affairs of public bodies. Finance officers seek the help and advice of investment bankers on market problems. The amount of time and energy the investment bankers can give finance officers is more limited than is true in the case of negotiated relationships—but investment bankers appear to take a conscientious interest in these problems.