Debunking Myths About Variable-Rate Demand Notes

BY ALLSPRING GLOBAL LIQUIDITY SOLUTIONS TEAM

Key takeaways

01 VARIABLE-RATE DEMAND NOTES (VRDNS) ARE NOT ONLY A CORE HOLDING IN MUNICIPAL MONEY MARKET FUNDS, THEY ARE USED BY OTHER INVESTORS, TOO.

02 FOUR SPECIFIC MYTHS ABOUT VRDNS DON'T HOLD UP UNDER SCRUTINY, INCLUDING THE MYTH THAT VRDNS ADD RISK.

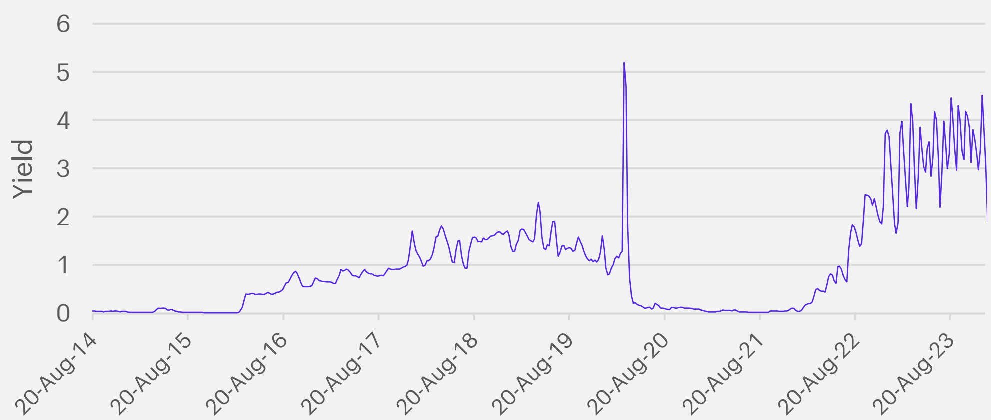
03 A REAL-LIFE EXAMPLE FROM THE RECENT CORONAVIRUS CRISIS SHOWS THAT VRDNS PERFORMED AS THEY WERE INTENDED.

VRDNs have historically been a core holding in municipal money market funds because of their effectiveness as a tool for managing a fund's liquidity and enhancing principal preservation.

At over $100 billion in size and composed of more than 10,000 individual securities,[1] the VRDN market is diversified and vast. And while the vast majority of issuers are public entities, with the securities being tax-advantaged, their specific characteristics make them appealing to crossover buyers such as taxable short-term investors as well as investors managing longer-term assets, such as bond funds, local government investment pools, and corporate treasurers. Despite the demonstrated resiliency of this asset and its appeal to a broad group of investors, a perception exists that VRDNs add risk to a portfolio or fund. This myth deserves to be debunked.

1. Municipal Securities Rulemaking Board

MYTH	REALITY
VRDNs are too complicated and therefore should be avoided.	On the face of it, the structure of VRDNs can be mystifying: The underlying security is a long-term security, so why is it an eligible investment for money market funds? VRDNs have a demand feature. This is a put option that enables an investor to tender the securities to a financial intermediary—such as a remarketing agent, tender agent, or trustee—and get their money back after a one-day or seven-day advance notification. This feature allows VRDNs to be considered under U.S. Securities and Exchange Commission (SEC) Rule 2a-7 as having a maturity equal to the next put date—either one or seven days—rather than its final maturity date. This makes VRDNs an eligible short-term security. The interest rate on VRDNs is subject to a periodic coupon reset, which means the coupon rate will generally change on a daily or weekly schedule based on the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index. This reset feature ensures that VRDN yields reflect the current interest rate environment. The vast majority of VRDNs improve their marketability and credit profile by adding third-party credit and liquidity enhancement, which ensure payment of principal and interest on tendered securities. The main types of credit enhancement include letters of credit and standby bond purchase agreements, both of which are typically provided by a highly rated bank or other financial institution. Letters of credit offer a somewhat higher degree of security as the obligation of the credit provider to pay principal and interest to bondholders within is unconditional. This does not mean that standby purchase agreements are more risky than letters of credit, but rather an issuer may have a good enough credit profile that a direct-pay letter of credit may not be necessary to appeal to investors. Finally, there are a number of issuers in the market that do not choose to enhance the liquidity of their securities—they provide self-liquidity. These issuers tend to have a rating on the higher end of the credit scale and thus don't need third-party enhancement to increase their marketability.
VRDNs add risk to a fund or portfolio.	VRDNs can actually enhance the risk profile of a fund. Contrary to conventional thinking about bonds, increases in VRDN yields do not mean that prices are falling. The demand feature on VRDNs ensures that the price at which the notes trade in the secondary market, as well as pricing in the portfolios, is always at par. This helps ensure investors do not experience losses in holding these securities. The periodic resets also ensure that the interest rates on these notes reflect current market conditions. These characteristics both contribute to the stability of a fund's net asset value. Prior to purchasing any security into the Allspring Money Market Funds, Rule 2a-7 requires us to determine that a security presents minimal credit risk to the fund and its investors. Our dedicated team of municipal credit analysts conducts a thorough analysis of the credit quality of the VRDN, including that of the underlying issuer, the terms and conditions of any credit or liquidity enhancement, and the credit quality of any liquidity provider. Only after we determine that credit risk is minimized is the VRDN deemed eligible for purchase into our funds.
High or increasing VRDN yields mean they should be avoided.	High VRDN yields are not necessarily indicative of credit deterioration or headline risk. VRDN yields can sometimes display more volatility than other short-term rates because they are more sensitive to secular changes in supply and demand than other types of instruments in the short-term markets.

MYTH	REALITY
High or increasing VRDN yields mean they should be avoided (continued).	Experience shows us that VRDNs are regularly subject to increases in yields during certain times of the year. At tax time, we typically see the biggest spike in rates as buyers liquidate tax-exempt investments in order to meet their tax obligations. In addition, long-term bond managers receive coupon payments at the beginning of the month and park the proceeds prior to reinvesting further out the curve. VRDN yields always tend to be richer early in the month and cheapen toward month-end. Finally, VRDN yields also tend to be a bit weaker at quarter-end and year-end as investors seek liquidity, a phenomenon similar to what we see in the repo market. At the margin, though, VRDN yields can be very sensitive to supply and demand imbalances, which typically account for extremes in yields. VRDN yields spiked during the recent crisis because investors raised cash and not because of credit deterioration. VRDN prices, however, remained stable because VRDNs can be put back at par on a daily or weekly basis. Chart 1: VRDN yields spike when supply outweighs demand though prices remain at par  Sources: Allspring Global Investments and Bloomberg Finance L.P. VRDN yields vary by specific issue. Relative supply and demand for an issue will vary based on many factors, such as rates in other related sectors (for example, commercial paper and government repurchase agreements). Other factors include the relative credit quality of the liquidity or credit support provider, whether the issue is subject to state taxes or the alternative minimum tax or is fully taxable, and dealer inventory levels.
VRDNs are just like auction-rate securities.	VRDNs are sometimes confused with auction-rate securities because they seem to share similar characteristics: Their interest rates both reset periodically and they are both tendered to a third party. The key difference is that VRDNs have contractual features that enable an investor to put back the security at par, so there is an obligated buyer providing liquidity. In contrast, auction-rate securities failed as the 2008 financial crisis unfolded because, as potential buyers disappeared, there was no backup to the auction or remarketing mechanism on which the liquidity of these securities depended. For this reason, it is important to note that auction-rate securities have never been an allowable investment for money market funds. VRDNs are not auction-rate securities. VRDNs were able to be sold in a timely manner in both the 2020 and 2008 liquidity crises.

Lessons from the crisis: A real-life example

Market seized up and became illiquid; VRDNs remained liquid

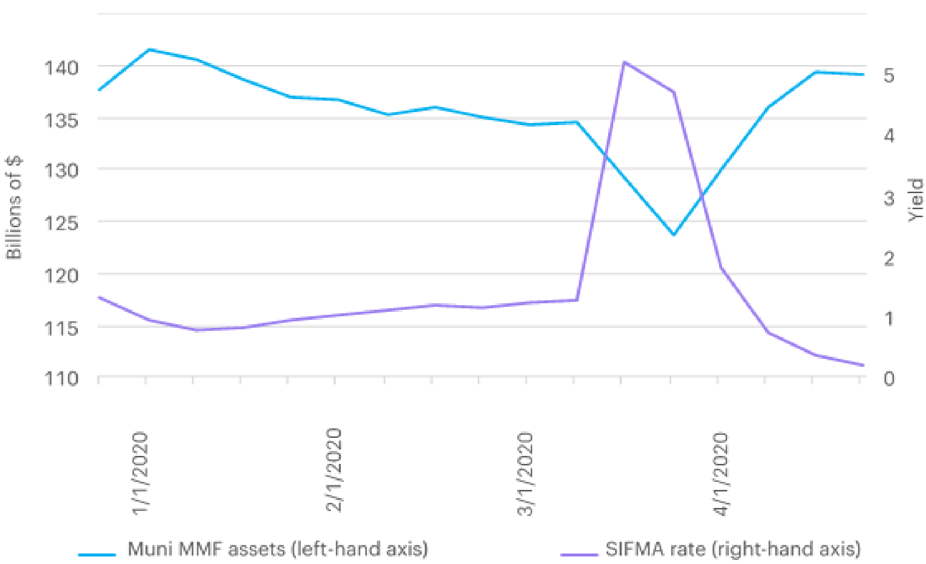
In times of market stress, the demand for liquidity increases across all asset classes as investors adjust to a rapidly evolving risk event. In this most recent case: the coronavirus. During the early days of the crisis, even U.S. Treasury securities were trading with substantial volatility. Other markets, such as commercial paper and short-term corporate bonds, became difficult to trade due to a lack of buyers. In real life, this meant that firms found their ability to raise money by either selling assets from a portfolio or issuing new debt.

Specific to VRDNs, the short end of the municipal market was not immune to the liquidity pressures experienced in other markets. VRDNs or municipal money market funds, which are heavily invested in VRDNs, are typically core cash positions in municipal bond funds. Significant fear-induced redemptions from municipal bond funds resulted in heavy selling of VRDNs, adding pressure on supply.

This led to a spike in VRDN yields as they moved from municipal bond funds and municipal money market funds to dealer balance sheets before finding new buyers. Weekly VRDN yields, as represented by the SIFMA Municipal Swap Index, moved from 0.80% on January 15 to 1.28% on March 11 to 5.20% on March 18 and finally recovered to post a 0.21% yield by the end of April.

While more than $10 billion in VRDNs were put back to broker-dealers at the height of the coronavirus crisis, VRDNs remained liquid and priced at par with no known issues to investors.

Chart 2: As redemptions increased, yields spiked



Sources: ICE, SIFMA, and Bloomberg Finance L.P. as of 30-Apr-22

Understanding SIFMA

The SIFMA Municipal Swap Index is a seven-day high-grade market index composed of tax-exempt VRDNs with certain characteristics. The bonds going into the index are selected from all eligible bonds reporting data through the Municipal Securities Rulemaking Board's Short-Term Obligation Rate Transparency System. To qualify for inclusion in the index, an issue must, among other criteria, reset weekly on a Wednesday, not be subject to the AMT, and have the highest short-term ratings (VMIG-1 by Moody's or A-1+ by S&P).

The index is overseen by SIFMA's Municipal Swap Index Committee and is calculated and published by Bloomberg every Wednesday by 4 p.m. ET. The index was created in response to industry participants' demand for a short-term index, which accurately reflected activity in the VRDN market.

SIFMA is the U.S.'s leading trade association, representing 80% of broker-dealers and half of asset managers.

You cannot invest directly in an index.

Conclusion

VRDNs are not only a core holding for municipal money market funds, they also are routinely used by a wider investor base, including prime and government money market funds, bond funds, and individual investors, to manage liquidity. The Allspring municipal bond funds typically have a VRDN exposure of anywhere from 5% to 25% based on the fund strategy. The Allspring municipal money market funds invest up to 100% in VRDNs. Our prime and government money market funds, on the other hand, employ a more opportunistic approach, increasing VRDN exposure when their rates yield more than other short-term investments such as repo or time deposits, though they may typically maintain some VRDN exposure most of the time.

While our process allows us to be opportunistic, our experienced team of credit analysts enables us to focus on the credit fundamentals and soundness of structure. Our holdings are generally very strong credits, composed of high-quality municipal issuers backed by bank liquidity. In times of stress, these credits performed exactly as expected and pay on time with no delays.

The safety and soundness of VRDNs has been demonstrated through various market conditions and economic cycles, including during both the recent coronavirus liquidity crisis and the earlier 2008 financial crisis. Offering liquidity, potentially high relative yields, and diversification, this security is an attractive investment for both our tax-exempt and taxable strategies.

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Bond values fluctuate in response to the financial condition of individual issuers, general market and economic conditions, and changes in interest rates. Changes in market conditions and government policies may lead to periods of heightened volatility in the bond market and reduced liquidity for certain bonds held by the fund. In general, when interest rates rise, bond values fall and investors may lose principal value. Interest rate changes and their impact on the fund and its share price can be sudden and unpredictable.

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