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Municipal Bonds: A Unique Fixed Income Asset Class

Typically like other bond investments, municipal bonds (munis), which are issued by state and local governments, offer investors regular interest payments and return of the principal at maturity. But munis are unique in that their interest payments are generally exempt from federal income taxes, and in some cases state and local income taxes as well. Munis may also offer high credit quality, low volatility relative to some other asset classes and potentially greater after-tax returns (for investors in higher tax brackets) than other fixed income securities of comparable maturities and credit ratings.

Investment Basics

Municipal bonds finance general operations or specific projects

Municipal bonds are issued by or on behalf of U.S. state and local governments, their agencies or authorities. The two main types of munis are general obligation (GO) bonds and revenue bonds.

GO bonds are issued to help finance a municipality's operating expenses or capital improvements. GO bonds are secured by the full faith and credit of the issuing municipality and are usually supported by the issuer's taxing power; property, sales and income taxes in particular are often earmarked for GO debt service.

Revenue bonds are issued to help finance specific projects or facilities and are secured by the revenues those projects or facilities generate. For example, revenue bonds are issued to fund construction of toll roads, bridges and water treatment centers and are secured by the tolls or fees these facilities collect. Unlike GO bonds, which are supported by the issuer's taxing power, revenue bonds may draw on the revenues specified in the bond offering for repayment of principal and interest.

Munis may offer tax advantages and high credit quality

Interest income earned on most municipal bonds is exempt from federal income taxes and may be exempt from state or local taxes if the bondholder resides within the state or locality that issued the security. Note that munis are not exempt from capital gains taxes, and some munis may be subject to the Alternative Minimum Tax (AMT).

Municipal bonds may therefore provide investors – especially those investors facing higher marginal income tax rates – with greater after-tax returns than many taxable bonds, including some Treasuries and corporate bonds with similar credit quality and maturities.

Another potential benefit municipal bonds typically exhibit is high credit quality. Many muni bonds are rated single-A or higher by the credit rating agencies (Standard & Poor's, Moody's Investors Service and Fitch). Historically, munis have been less likely to default than corporate bonds with equivalent credit ratings, and in the event of default, munis have offered higher recovery rates than corporates, according to Moody's.

Managing risk and investing in municipal bonds

Nevertheless, like all fixed income securities, municipal bonds do carry credit risk, as well as interest rate risk. Municipal bonds tend to perform better when the local and national economies are growing; they become more vulnerable to credit rating downgrades and even default during recessions, when state and local revenues, as well as federal funding, may decline.

To manage the risks and seek attractive investment returns in muni bonds, investors may consider:

Investors have traditionally bought emerging market bonds (both external and local currency instruments) for several reasons.

- **Credit quality:** Choosing bonds of high or improving credit quality can be beneficial because credit quality can change rapidly, which may affect the value of individual bonds and even entire sectors of the municipal bond market.
- **Economic outlook:** In challenging environments, investors may find more attractive returns by targeting essential service revenue bonds and bonds backed by dedicated taxes. These kinds of munis have dedicated sources for their debt service, so they are less likely to be affected by budget cuts or political concerns.
- **Yield and performance characteristics:** Most munis have call options, allowing the issuers to retire the bonds before maturity, and issuers typically exercise these options when interest rates are low, which is a less attractive environment for reinvesting. Investors should know the exact terms of the call options and the potential investment cost. They should also examine coupon, maturity and liquidity before selecting individual muni bonds.

Individual investor base may lower volatility in muni investments

Historically, returns on municipal bonds have been generally less volatile than those on many other asset classes, including equities and long-term Treasuries. Individuals typically make up the majority of investors in the municipal bond market, and they tend to buy and hold munis to maturity rather than actively trade the bonds. This contrasts with many other fixed income sectors where institutional investors tend to dominate.

In addition to buying specific municipal bonds on their own account, individual investors can be represented by mutual funds, bank trust departments, exchange-traded funds, closed-end funds and money market funds. Other large buyers of municipal bonds are property and casualty insurance companies, banks, corporations and arbitrage investors. Both individuals and institutions may invest in buy-and-hold municipal bond ladder strategies, which are designed to generate periodic income from bonds with staggered maturity dates.

Conclusion

In addition to their general exemption from federal income taxes, and in some cases, state and local taxes, municipal bonds may offer several advantages, including higher after-tax returns than many other taxable bonds, high credit quality and relatively low volatility.

A word about risk: Past performance is not a guarantee or a reliable indicator of future results. Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax. Corporate debt securities are subject to the risk of the issuer's inability to meet principal and interest payments on the obligation and may also be subject to price volatility due to factors such as interest rate sensitivity, market perception of the creditworthiness of the issuer and general market liquidity.

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The credit quality of a particular security or group of securities does not ensure the stability or safety of the overall portfolio.

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