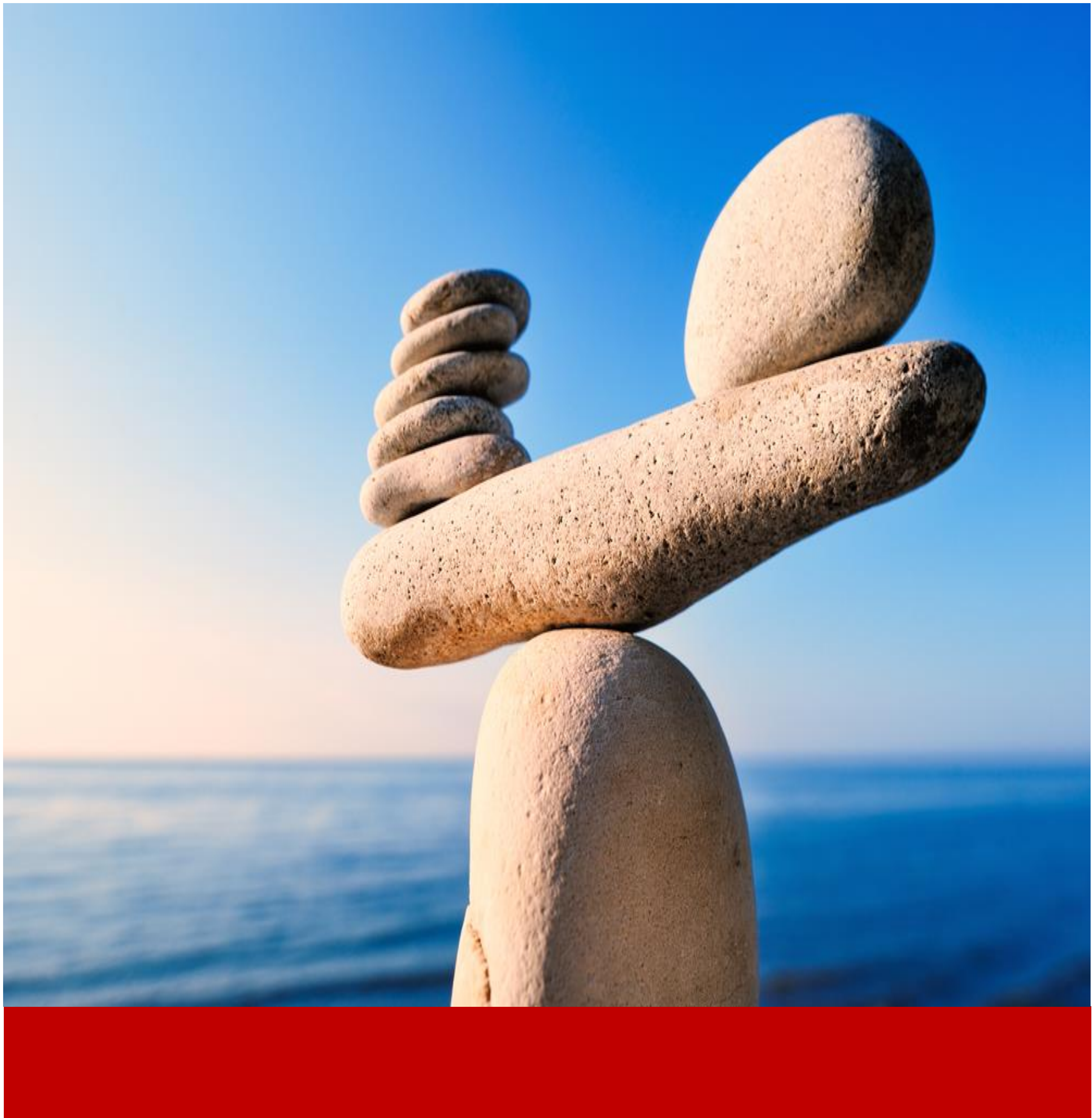


When do Municipal Bonds Make Sense in a Portfolio?

Red Paper

The purpose of this Red Paper is to help financial advisors understand when and why municipal bonds make sense for a client's portfolio. Municipal bonds ("munis") are sold by local and state governments to fund public projects like building new schools and repairing city sewer systems. They represent an attractive investment for individuals looking for assets that provide tax-advantaged income. In general, interest payments from muni bonds aren't subject to federal taxes. If the bonds are issued by the state in which the investor resides, they're free of state taxes. And if they're issued by the city in which the investor resides, they're free of city taxes. Munis generally make sense for investors in the 25 percent federal tax bracket and higher.

Default Rates

With any investment, your client needs to be aware of the risks involved. The good news is that defaults in muni bonds are very rare. Understanding what causes bond defaults can help make smart investment decisions. At the most basic level, muni bonds default when their issuers (states, cities, or communities) find themselves unable to repay their debts in a timely fashion. On the rare occasion that a muni issuer does default, the problem can often be traced back to issues such as:

- Poor project and resource management.
- Overestimated revenues.
- Unanticipated costs.
- Inflated government salaries, pensions, and benefits that draw on limited funds.
- Financial mismanagement and fraud.

Muni bonds are not immune to defaults. In fact, back in 2013, Detroit defaulted on its bonds when the city filed for bankruptcy. In the grand scheme of munis, however, Detroit is by far the exception, not the rule. Since Detroit's bankruptcy filing, no U.S. city or county has commenced a Chapter 9 bankruptcy process.

Here are some more impressive facts about muni bond defaults:

- Since the 1970s, municipal bond defaults have been rare. S&P reported only 47 muni bond defaults between 1986 and 2011, and Moody's reported just 71 defaults between 1970 and 2011.
- Of Moody's 71 reported defaults, only 5 stemmed from general obligation bonds.
- Municipal bonds are 50 to 100 times less likely to default than comparably rated corporate bonds.
- Since 1933, there has not been a single state general obligation bond to default. Prior to the Great Depression, the only other state defaults on record can be traced back to the period of the Civil War.
- There have been no Aaa-rated municipal bond defaults since 1970, and since then, only 0.01% of muni bonds with an Aa-rating or below have defaulted.

On the rare occasion that a bond issuer defaults on a payment doesn't mean that all is lost. A default doesn't cancel out a bond or make the issuer's obligation to repay go away. Owning bonds that go into default is never a desirable situation, but as an investor, it pays to focus on recovery. The recovery rate (the extent to which bondholders end up collecting what they're

owed following a default) for a general obligation bond is close to 100%. The reason is that with a general obligation bond, the issuer is allowed to use its full taxing power to raise enough money to repay bondholders. A city faced with a financial crisis, for example, can increase property taxes to make good on its debt obligations.

Historically, municipal bond recovery rates have been pretty high overall (about 60% on average between 1970 and 2013). The rate for corporate bonds, by contrast, was only 48% between 1987 and 2013. While a large percentage of defaults over the past 40 years stemmed from the housing and healthcare sectors, in many cases, investors were made whole and ultimately saw recoveries of 100%. Even Detroit saw a 74% recovery for holders of the city's general obligation bonds.

Another thing to keep in mind is that bond insurance can help reduce the losses associated with a default. Though not all municipal bonds carry insurance, those that do offer investors an added layer of protection against financial losses in the event of a default, as insurance companies are required to make payments when their bond issuers cannot.

Individual Bonds vs. Funds

One of the first questions for investors in munis is whether to buy individual bonds, mutual funds or exchange-traded funds ("ETFs"). The advantage of buying individual bonds is that the investor will get all of their money back at maturity, assuming the issuer doesn't default.

But most individuals don't have the capability to thoroughly analyze individual bonds and it's more difficult than corporate bonds, where balance sheets are easier to evaluate. Furthermore, buying individual muni bonds can be quite expensive and typically the trading commission is baked into the price rather than charged separately. So investors really don't know what they're paying in commissions and bond brokers aren't eager to provide bargains, especially to investors buying bonds in small denominations.

In general, $25,000 is viewed to be the minimum size that makes sense if a client wants to buy an individual municipal bond and investors will need at least 20 different issues to gain adequate diversification. That amounts to a minimum of $500,000 in total for a well-diversified bond portfolio. Because of the substantial amount needed for a diversified bond portfolio, we utilize mutual funds in our tax-sensitive wrap accounts.

Finding Yield with Less Volatility

Short-duration, high-yield municipal bonds historically have featured attractive yields and have carried less interest-rate risk than other fixed-income securities. Government bond yields in many of the developed economies haven't just hit the floor, they've entered the basement. We live in a low-yield and income investors are looking for investments that can provide the opportunity for solid income when yields are so extremely low.

Short Duration High Yield Munis:

- Offer attractive tax-free income.
- Have had much less volatility than longer-duration high-yield municipals.
- Have had low correlation with many other fixed income sub-categories.

First, though, here's a bit of background on the current environment. According to J.P. Morgan, the amount of negative-yielding debt instruments globally has reached approximately US$10 trillion (as of June 30, 2016). The preponderance of negative yields in developed economies is shown in Table 1, which renders a "heat map" of global government bond yields across the maturity spectrum. While U.S. government yields haven't yet hit the red zone, they still are near historical lows.

Table 1. Government Debt in Many Nations Features Below-Zero Yields

Yields (in percent) on various maturities of developed-nation government bonds, as of June 30, 2016.

Country	1-Year	2-Year	3-Year	4-Year	5-Year	6-Year	7-Year	8-Year	9-Year	10-Year	15-Year	20-Year	30-Year
Switzerland	-1.15	-1.19	-1.17	-1.10	-1.05	-0.96	-0.89	-0.77	-0.67	-0.61	-0.41	-0.26	-0.11
Japan	-0.33	-0.30	-0.29	-0.31	-0.31	-0.32	-0.32	-0.30	-0.28	-0.22	-0.10	0.07	0.13
Germany	-0.64	-0.66	-0.66	-0.64	-0.57	-0.54	-0.46	-0.38	-0.26	-0.13	-0.08	0.12	0.38
Netherlands	-0.61	-0.60	-0.58	-0.56	-0.42	-0.40	-0.28	-0.17	-0.04	0.08	0.26	0.32	0.51
Finland	-0.61	-0.58	-0.57	-0.47	-0.42	-0.30	-0.23	-0.10	-0.02	0.14	0.37		0.54
Belgium	-0.58	-0.59	-0.55	-0.51	-0.41	-0.32	-0.23	-0.07	0.09	0.23	0.53	0.60	1.03
Austria	-0.58	-0.55	-0.5	-0.47	-0.37	-0.33	-0.30	-0.25	0.04	0.20	0.16	0.62	0.86
France	-0.55	-0.55	-0.52	-0.45	-0.36	-0.29	-0.20	-0.09	0.05	0.18	0.49	0.73	0.91
Denmark		-0.61			-0.35			-0.17		0.07			0.45
Sweden		-0.63		-0.50	-0.29		-0.14	0.03		0.25	0.77	1.12	
Ireland	-0.40	-0.37	-0.27	-0.22		-0.06	0.15	0.29	0.45	0.51	0.81		1.24
Italy	-0.21	-0.11	-0.04	0.07	0.29	0.49	0.67	0.9	1.09	1.26	1.52	1.92	2.27
Spain	-0.24	-0.20	-0.12	0.01	0.18	0.27	0.49	0.84	0.97	1.16	1.48	1.88	2.24
United States	0.45	0.58	0.69		1.00		1.28			1.47		1.86	2.29

Source: Bloomberg and U.S. Treasury Department. Data are as of June 30, 2016. **Past performance is no guarantee of future results**.

Where can investors turn in such a yield-scarce environment? One attractive option might be the municipal bond market. Investors recognize that munis historically have provided strong returns with relative stability, especially in the face of global market volatility over the past few years. The chart below shows municipal bond's attractive profile versus U.S. government securities of comparable maturity. Our tax-sensitive wrap accounts utilize mutual funds that are primarily long muni bonds and munis with 5-10 year durations.

Chart 1. Muni Bonds Recently Offered Higher Yield, with Less Risk, Than U.S. Treasuries

Yield/tax-equivalent yield and 20-year standard deviation for indicated categories, as of June 30, 2016.

Source: Barclays and Citigroup. Municipal bond maturities represented by components of the Barclays Municipal Bond Index; U.S. Treasury maturities represented by specific-maturity Citi Treasury Benchmark Indexes. Data are as of June 30, 2016. At the 28% tax bracket, tax-equivalent yields would be 1.63%, 2.18%, 2.82%, and 3.10% for the Barclays Municipal Bond 5-Year, 10-Year, 20-Year, and 22+ (Long) Indexes, respectively. Tax-equivalent yield calculation for the municipal indexes above assumes the top marginal tax bracket of 43.4% on investment income, which includes the 39.6% income tax rate and the 3.8% in Medicare tax. This tax rate does not factor in the effect of AMT (alternative minimum tax) or taxes in your individual state. Tax-equivalent yield will vary based on an investor's tax bracket. **Past performance is no guarantee of future results**. Lower-rated bonds may carry greater risks than higher-rated bonds. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state, and local taxes may apply.

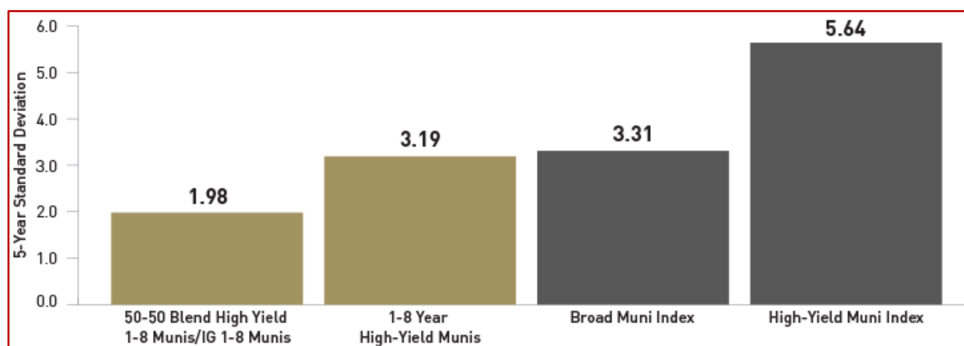
For investors who desire tax-free income, but are concerned about potential interest-rate increases over time, shorter-dated munis with lower duration ought to merit consideration. And within that category, one specific segment may offer the most compelling opportunity: short-term high-yield munis, which historically have provided higher tax-equivalent yield versus government bonds of comparable maturity. Investors focused on volatility also should note that while this asset class is high yield (i.e., rated below investment grade) due to its short-duration nature, it

has displayed less volatility than the broad muni market and only a fraction of that of the overall high-yield muni category, as seen in Chart 2.

The chart also depicts another intriguing possibility, a portfolio with an equal blend of short-term high-yield munis and investment-grade munis of similar maturity. Such a combination would result in a further reduction of volatility, while still retaining a sizable component of high-yield securities to augment income.

Chart 2. How Do Short Duration, High-Yield Munis Compare in Terms of Historical Volatility?

Five-year standard deviation (through June 30, 2016) for indicated categories.



Source: Barclays. One-to-eight year high-yield munis represented by the Barclays High Yield Municipal Bond 1-8 Year Index; one-to-eight year investment grade (IG) munis represented by the Barclays Municipal Bond 1-8 Year Index; the broader municipal market represented by the Barclays Municipal Bond Index; the high-yield municipal market represented by the Barclays High Yield Municipal Bond Index. **Past performance is no guarantee of future results**. Lower-rated bonds may carry greater risks than higher-rated bonds. Income from municipal bonds may be subject to the alternative minimum tax. Federal, state, and local taxes may apply.

Avoiding Some of the Common Bond Traps

While the interest payments on municipal bonds are usually exempt from federal income taxes, other taxes may apply. It's important to know the general rules because municipal bonds are one of the few investments available to income-oriented investors looking to reduce their income tax bills. Here are seven types of taxes that could apply if your client buys municipal bonds.

1. **Alternative Minimum Tax.** There are two parallel income tax systems in the United States: ordinary income tax and alternative minimum tax ("AMT"), which disallows a number of deductions that are allowed in the ordinary income tax code. Taxpayers must calculate their tax under each system and then pay whichever is higher (ordinary or AMT).

Income from some municipal bonds for example, those that fund stadiums, airports or more business-like enterprises might be subject to AMT. If your client has to pay AMT and hold such a bond, their interest income would generally be taxed at 28% (or more, if they're in the AMT exemption phase-out range). Effectively, that means the yield on a municipal bond paying 2.5% would drop to 1.8%.

2. **Capital Gains Tax.** In general, individual investors should hold a bond until maturity. However, if your client needs to sell earlier and they receive a price greater than the cost basis (acquisition price after adjusting for any premiums paid or discounts received) the gain will be subject to capital gains tax.

3. **De Minimis Tax.** The de minimis tax rule requires individual investors to pay higher taxes on any capital gains resulting from the sale of a muni that was purchased at a discount of more than 0.25% for each year remaining until maturity. To avoid the de minimis tax rule, consider purchasing bonds priced at par or a premium to their face value. Paying a premium may mean having to make adjustments to your client's tax filing, but the associated tax benefits may more than offset the added complication. In addition, if a bond is selling at a premium, it's likely because it is offering a high coupon rate.

   For example, take a bond that matures in 10 years with a face value of 100. If this bond was bought for less than 97.5 (100 – [0.25 × 10 years]), your client would be required to pay ordinary income tax on any capital gain resulting from the discount. The tax rate on ordinary income is generally higher than that on capital gains.

4. **State Income Tax.** If your client purchases a bond from their home state, generally the interest payments received will be exempt from state income taxes. However, interest paid on bonds from outside of their home state typically will be subject to state income tax. If your client lives in a state with low tax rates or one that issues a minimal amount of municipal bonds, we suggest looking for munis outside of their state. The added benefits of diversification and higher yields might make up for the hit your client would take by paying state income taxes.

5. **Increase in Taxation of Social Security Benefits.** Although municipal bonds generally aren't subject to federal taxes, the IRS does include income from such bonds in modified adjusted gross income ("MAGI") when determining how much Social Security benefit is taxable. If your client is receiving Social Security benefits, we suggest reviewing IRS Publication 915, "Social Security and Equivalent Railroad Retirement Benefits," which discusses the taxation of retirement benefits, to determine how this might apply to your client's individual situation.

6. **Increase in Medicare Premiums.** If your client is covered by Medicare, the federally tax-exempt interest from municipal bonds may increase the amount they pay for Medicare Part B or Medicare prescription drug coverage. We don't believe paying an additional Medicare premium justifies not investing in municipal bonds. Given that the MAGI will also include income from other sources, such as dividend income and interest income from taxable

bonds, avoiding municipal bonds will not necessarily allow your client to avoid the increase in Medicare premiums.

7. **Taxable Municipal Bonds.** A small minority of munis are taxable. For example, interest paid on bonds issued to help fund an underfunded pension plan or bonds issued under the Build America Bond ("BAB") program is federally taxable. Taxable muni bonds generally yield more than tax-free bonds to make up for the difference. For investors in tax brackets below 25% and investing in taxable accounts, or those investing in either Roth or traditional IRA accounts, we believe that taxable municipal bonds can make sense compared to other taxable bonds, all else being equal.

The bottom line is that municipal bonds offer significant tax advantages and could make sense in the portfolios of many income-focused investors. However, the details matter. If your client is highly tax-sensitive and would like to invest in these securities, you will want to make sure your client understands how the tax traps mentioned above might affect their portfolio.

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