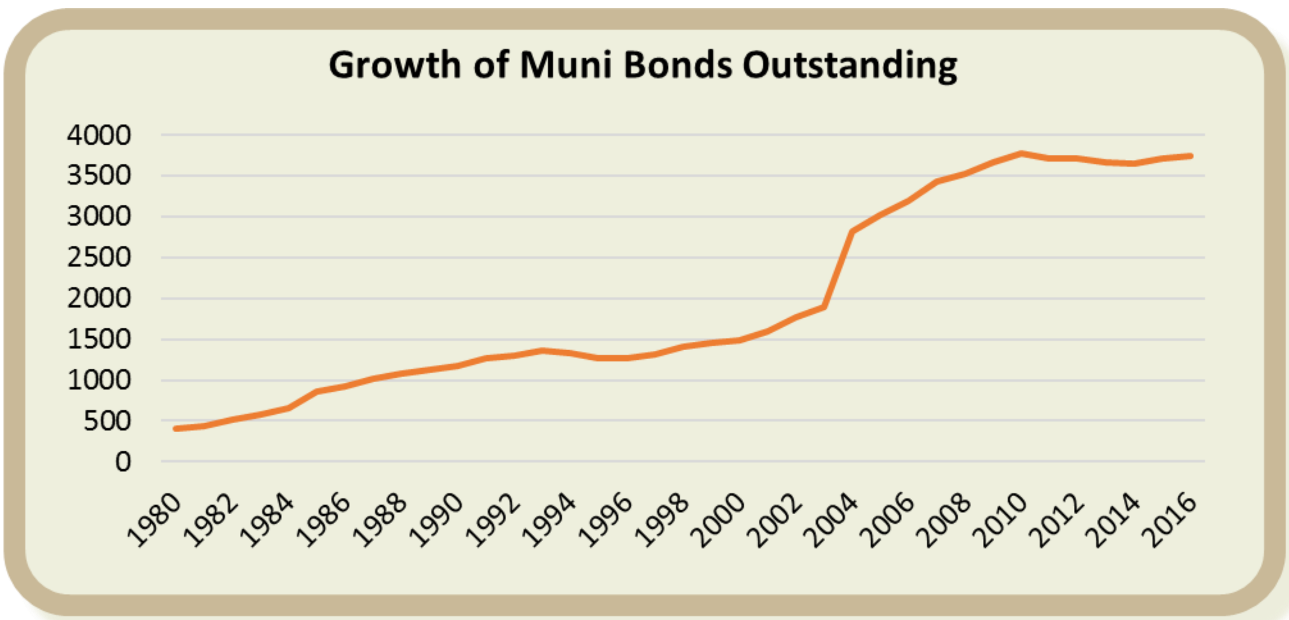
Muni Bonds in your Portfolio

Evaluating the Pros and Cons

By Kevin Chambers

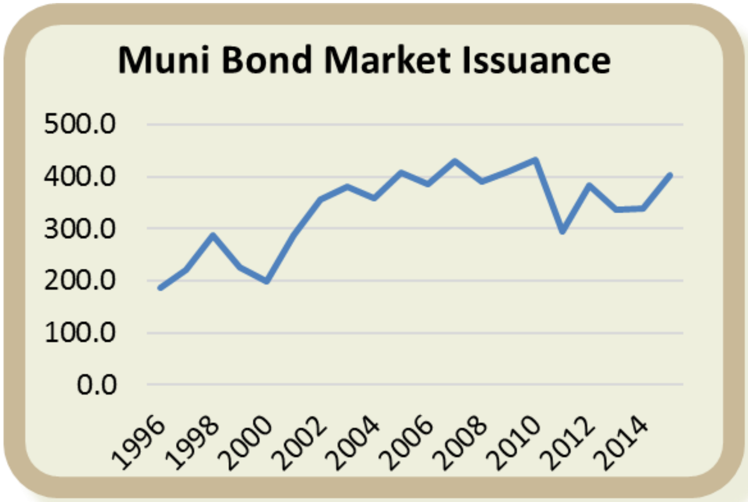
Municipal Bonds can be a valuable tool in a financial portfolio. They have special tax advantages and can offer higher yields. Muni bonds are debt securities just like other bonds, however, the issuers are smaller entities like states, counties, and cities. They are most often used to fund large construction projects like schools, airports, or water treatment centers.



Source: SIFMA

Types of Muni Bonds

There are two general types of muni bonds: General Obligation and Revenue. GO bonds are issued by governments. They are usually backed by property taxes. School bonds are GO bonds and the citizens of the city pay slightly higher property taxes to fund the interest and principal payments. Because it affects taxpayers, GO bonds have to pass a vote of the community. Revenue bonds are issued by either governments or private entities and are backed by the revenue of the project. Revenue bond projects included toll roads and many sports stadiums. Revenue bonds can be issued without a vote of the constituents because they do not affect the tax rate. If the issuer of the revenue bond does not have direct control over the revenues of the project they are called a “conduit issuer.” The third party which is generating the revenue is responsible if the project goes into default, not the issuer.



Source: SIFMA

Tax Advantages

Muni bond income is exempt from federal taxes. They are also exempt from state taxes as well, as long as the investor is a resident of the state that issued the bonds. This makes these bonds useful in accounts for people in high-income brackets.

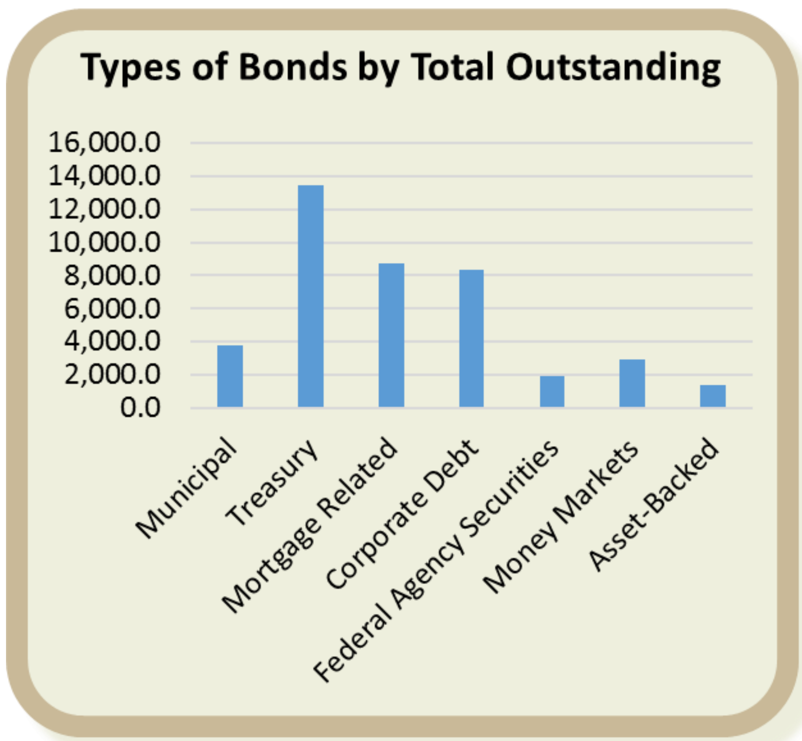
Risks

Municipal bonds are considered riskier than US Government bonds. The issuing entities, cities or counties, are much smaller and are more susceptible to outside factors that could limit their ability to pay for bonds. Just like other bonds, Muni bonds are given a credit rating that gives investors a signal for the risk level of the bond. The size of the issuer, the type of bond, the political situation, the economy, and the type of project all influence the risk of the bond.

In general, larger cities are considered safer than small cities. The larger cities have more taxpayers and more flexibility than their smaller counterparts. However, even big cities can be rated low; for example, Detroit bonds were rated as "junk" bonds, below B (Moody's).

GO bonds are considered safer than revenue bonds because they are backed by the whole community of taxpayers, not just an individual project. The project of a revenue bond also affects the risk assessment significantly too. For example, a toll road on a very popular thoroughfare that is used heavily every day is much more likely to get paid back than a sports stadium for a lower level team that is used once every two weeks for 5 months out of the year.

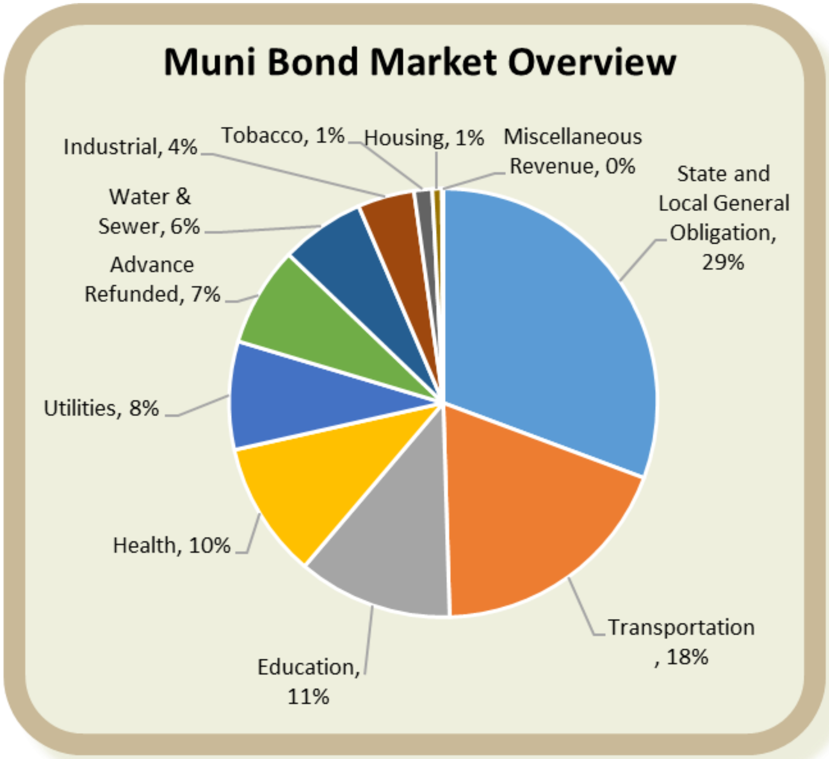
The risk of an individual bond is usually reflected most obviously in the interest rate. Higher interest rate bonds are higher risk. The interest rates need to be higher to compensate the investors for taking on the higher possibility of default.



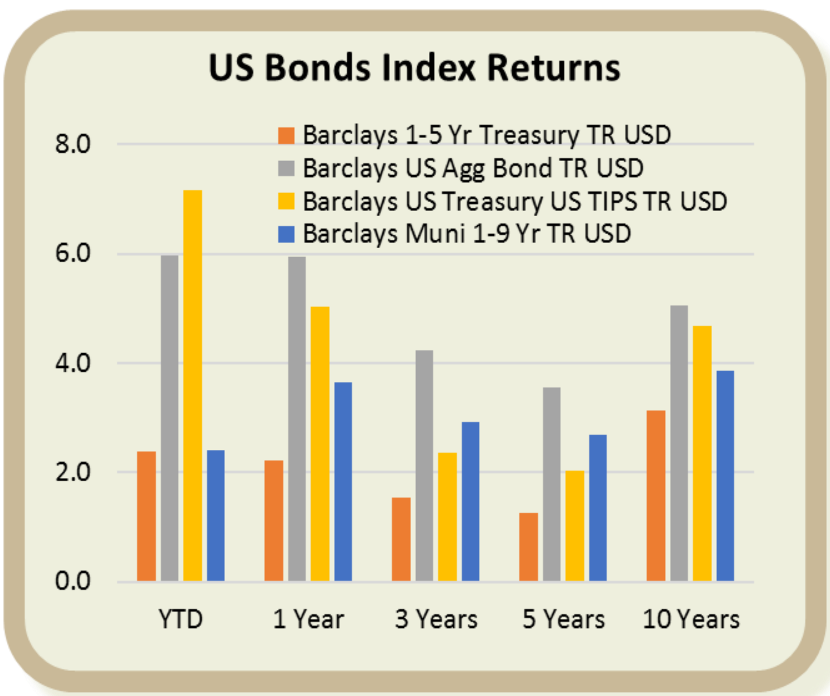
Source: SIFMA

Muni Bond Market

At the end of the first quarter this year, there was $3.7 trillion municipal debt outstanding. That accounts for about 9% of total US bonds. It is the fourth largest bond market in the US behind US treasuries, mortgage securities, and corporate debt. The Morningstar Muni Bond category average can give a rough approximation of the allocation of the market. The largest allocation for the mutual funds in this category is state and local general obligation bonds at about 30% of the total allocation. This is followed by transportation bonds at 18%, education bonds at 11%, healthcare at 10%, and utilities at 8%. Of course, the allocation breakdown might be intuitive when you think about what the largest bonds that counties, states, and cities issue bonds for: big road, school, and emergency services projects.



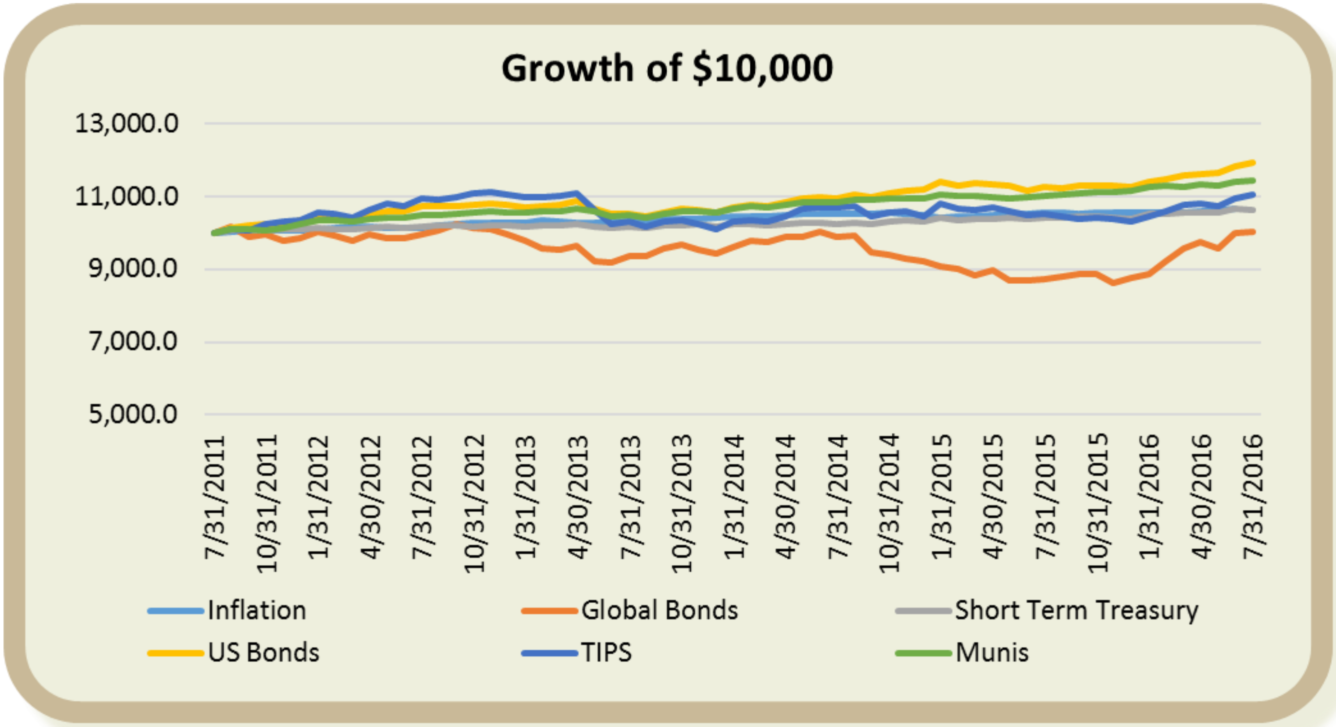
Source: Morningstar



Source: Morningstar

Performance

Muni bonds have been a fairly consistent bond asset classes over the last 10 years. The worst year for muni bonds in the last 10 years was 2013, same as the rest of the bond markets. Muni bonds returned 0% while the general bond market (BC AGG) returned -2%. Even though the muni bond market has not lost money in the last 10 years, it has lagged behind other markets. Annualized, the Muni bond index has returned 3.9% for the last 10 years. This underperforms the general US bond market, international bonds, and TIPs. Over the last 5 years, however, it only lags behind the BC Aggregate. Comparably, it also has a fairly low standard deviation over the last 10 years at 2.5. That is behind the BC Agg at 3.2

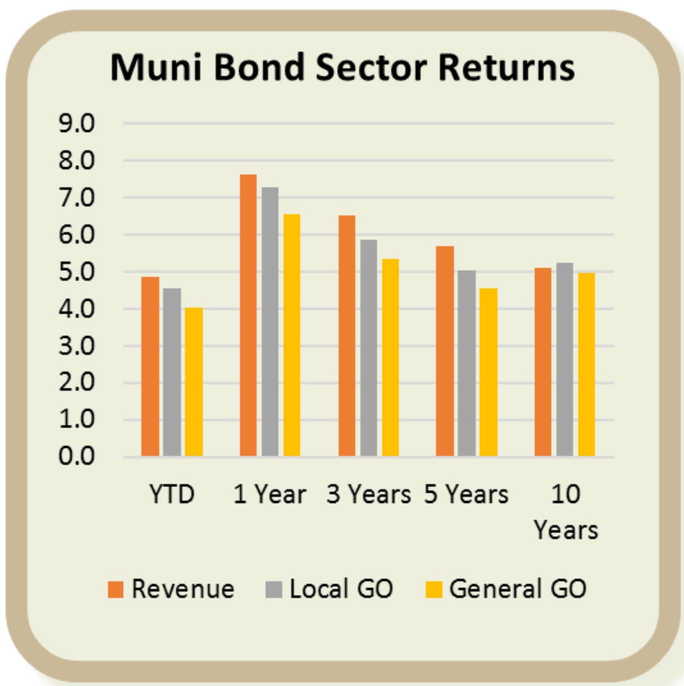


Source: Morningstar

and TIPs at 6.3. The different types of Muni bonds (Revenue vs. GO) have returned about the same over time, with no clear favorite.

When Muni's Go Bad: Puerto Rico

Puerto Rico was able to issue all of their bonds as municipal bonds making them not only exempt from Federal taxed, but also tax-exempt in all 50 states. This made the bonds very attractive to many investors. The Puerto Rico government wanted to capitalize on investors wanting to give them money and over-extended their debt. They issued billions of dollars in debt, and as their economy waned, Puerto Rico was unable to pay for the interest payments. The island struggled with 12.2% unemployment and now about 1/3 of the total tax revenue brought into the country is used to cover interest payments to mainland US investors (Sweet, 2016). Puerto Rico had to default on about $2 billion earlier this year. This caused massive losses for investors that owned these



Source: Morningstar

bonds. That is the problem for many muni bonds. When things go bad, they can go really bad. Since the entities are small, there are often not sufficient mechanisms to accommodate bankruptcy.

Muni's in Your Portfolio

Muni bonds only make sense really in taxable accounts. They yield a much lower income than other types of bonds. The average SEC yield on an intermediate muni bond fund is around 1.2% versus 3% for intermediate corporate bonds and 2.6% for intermediate general bond funds. Keep in mind that the yield is adjusted when you don't have to pay taxes on the income. The diversification that muni bonds provide is nice; however, they are closely correlated with the rest of the bond market, so the diversification effects are actually limited. The main advantage of muni bonds is their tax status. If you are a very tax conscious investor, they have a place in your taxable investment accounts. Because of the lower yield, they do not make a lot of sense for tax sheltered retirement accounts or for those in lower tax brackets.

Muni's going forward

Like most investments, it is difficult to predict exactly what will happen for the future of muni bonds. Cities and states will still need to build roads, hospitals, schools, and sports stadiums. They are a consistent investment that can return a solid after tax income. Some cities have become creative with how they issue their bonds. In 2014, Denver offered a "crowdfunded muni-bond project" which issued small $500 bonds to only local investors. They sold out of the allocated $12 million in 60 minutes to support a project called "Better Denver." The project raised money to improve public facilities around the city. Possibly more cities will go down the "mini muni" bond path as a way to raise funds (Ebi, 2014). This type of lending could capitalize on the desire for people to spend their money locally.

Ongoing, muni bonds will be an important part of many high net worth portfolios. It will be interesting if the poor press surrounding the Puerto Rico debt crisis scares away some investors or if the market remains strong. With historically low rates, all fixed income products are yielding significantly lower income than even just 10 years ago. Hopefully, interest rates will start to rise and help the whole asset class become more profitable.

Works Cited:

Ebi, K. (2014, October). How crowdfunding and mini-bonds are paying for Better Denver. Smart Cities Council.

Sweet, K. (2016, May 2). Puerto Rico's worsening debt crisis is dimming the economic outlook for the U.S. territory and putting pressure on Congress to help resolve the situation but it is having little effect on the market for municipal bonds and most investors. US News and World Report, pp. http://www.usnews.com/news/business/articles/2016-05-01/q-a-puerto-ricos-debt-crisis-explained.