

Investment-grade municipal bonds are viewed by many financial advisors as a conservative investment tool, but municipal bonds are not risk-free.

Municipal Bonds: Back to Basics

The risks, yield, and diversification potential of this key asset class explained.

The municipal bond marketplace is large and diverse, with over 1.5 million issues aggregating approximately US\$ 2.7 trillion *par value* outstanding in the United States. How do advisors use *municipal bonds*¹ as part of a portfolio diversification strategy? The answer varies depending on a number of basic factors addressed within this *Practice Essentials*. If an investment objective for part of a portfolio is to preserve capital while generating a tax-free income stream, then advisors will usually consider municipal bonds.

Municipal Bonds and Their Role in an Investment Portfolio

Bonds are debt instruments. The issuer of the debt borrows money, known as *principal*, from investors in order to finance projects or meet budgetary needs. In return, the issuer pays interest (usually semi-annually) and repays the principal amount at the end of the borrowing period, called the *maturity* of the bond. Municipal bonds are a particular class of bond instruments. Municipal bonds are issued by states, local governments, and political subdivisions such as school districts, or by governmental agencies and authorities for a wide variety of basic services and public purposes. Many major infrastructure, educational, housing, health care, and public utilities are financed through the use of municipal bond proceeds. Municipal bonds may be grouped into a few basic categories:

General Obligation Bond	Secured by the full faith, credit, and taxing power of the issuer. At local government level, typically secured by a pledge of the issuer's ad valorem taxing power. At state level of issue, generally based upon appropriations made by the state legislature for the purposes specified.
Revenue Bond	Payable from identified sources of revenue. Pledged revenues may be derived from operation of the financed project, e.g. a bridge toll for a bridge reconstruction project. Other examples of revenue bond secured projects are single and multi-family housing, as well as electric and gas production and transmission.
"Double Barrel" Bond	Municipal bond issues in which the bonds are secured by specifically pledged revenues and the full faith, credit, and taxing power of the issuer.

¹Municipal bond terms shown in italics are defined by the Municipal Securities Rulemaking Board (MSRB) and may be found in its glossary of municipal security terms on the MSRB's Electronic Municipal Market Access (EMMA) website at <http://emma.msrb.org/EducationCenter/Glossary.aspx>.

The American Recovery and Reinvestment Act of 2009 (ARRA)

The American Recovery and Reinvestment Act of 2009 (ARRA) introduced a new type of municipal security, Build America Bonds (BABs). The BAB program allows state and local governments to issue an unlimited amount of taxable debt through the end of 2010. Issuers receive a direct payment (subsidy) from the U.S. Treasury, lowering their overall borrowing cost. Discussions are ongoing to extend the program beyond its current "sunset" date as well as to expand the program to include refundings. In 2009, over US\$ 60 billion BABs were issued with greater volume anticipated in 2010.²

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in 2009.²*

Municipal Bond Price and Yield

Historically, municipal bonds have had a lower nominal yield in comparison to corporate bonds. The lower nominal yield is associated with the federal tax-exemption³ of the interest.

Municipal Bond Price: The best way to understand the concept of "price" is to think of price as "cents on the dollar." All bonds are basically quoted as cents on the dollar: 100 is par or 100 cents on the dollar. A price of 100 would mean that US\$ 10,000 worth of bonds would cost an investor US\$ 10,000. A price of 95 means that US\$ 10,000 worth of bonds would cost an investor US\$ 9,500. A price of 103 means that US\$ 10,000 worth of bonds would cost an investor US\$ 10,300.

Municipal Bond Yield: The yield is the overall return that investors receive from a bond investment. When a bond is priced at 100, or par value, the interest rate and the yield will be almost identical. If the bond trades for more than 100, the yield will generally be lower than the interest rate. If the bond trades for less than 100, the yield will generally be higher than the interest rate.

In general, when interest rates in the market rise, the price of an existing municipal bond will fall. The inverse is also true, so it is said that price and yield for a municipal bond are inversely related.

² Sources: Bond Buyer and SIFMA Municipal Issuance Survey

³ Not all municipal bond interest is exempt from Federal taxes.

Understanding Risks Associated with Holding Municipal Bonds

Municipal bond *ratings* are issued by credit rating agencies and express forward-looking opinions about the *creditworthiness* of issuers and obligations. The term creditworthiness refers to the question of whether a bond or other financial instrument will be paid according to its contractual terms. Higher credit ratings reflect an expectation that the rated issuer or obligation should default less frequently than issuers and obligations with lower ratings, all other things being equal. Ratings are not measures of absolute default probability; rather, they express a relative ranking of creditworthiness. Ratings can change over time depending on the relative creditworthiness of the issuer or the relative strength of the security underlying the bonds. A ratings downgrade indicates a negative change or a perceived weakness in one or more of the factors comprising the rating. These factors include, but are not limited to the local economy, finances, debt, management, and, in the case of revenue bonds, issues specific to a project such as construction delays, cost overruns, and environmental issues.

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The *Municipal Bond Fairness Act* (HR 6308), introduced on September 9, 2008, included the following table highlighting bond default rates up to 2007 for municipal versus corporate bonds by rating and rating agency (shown here: S&P data only). For the period covered by the table, the historical default rates for municipal bonds have been lower than those of corporate bonds. However, it is important to mention that historical default rates may not be indicative of future default rates.

Cumulative Historic Default Rates (in percent)

Ratings Categories	S&P	
	Municipal	Corporate
Aaa/AAA	0.00	0.60
Aa/AA	0.00	1.50
A/A	0.23	2.91
Baa/BBB	0.32	10.29
Ba/BB	1.74	29.93
Caa-C/CCC-C	8.48	53.72
Investment-Grade	0.20	4.14
Non-Investment-Grade	7.37	42.35
All	0.29	12.98

Credit and Market Risk

Risks associated with any fixed income investment can be broken down into two core areas: credit risk and market risk.

Municipal bonds may be a good choice for diversification since their returns are typically not highly correlated with equity returns.

Credit risk: *Investment-grade* municipal bonds are viewed by many investment professionals as a conservative investment tool. However, they are not risk-free. Investors in municipal bonds are concerned primarily with *default*. *Default* is a failure to pay all or part of the promised principal or interest, known as *debt service*. Municipal bond default rates have been fairly low over the period covered in the table above, particularly in the General Obligation sector. Investment-grade municipal bonds are considered by market participants to be those bonds rated BBB- or higher. Municipal bonds rated below BB+ are considered speculative, or *non-investment-grade*, by market participants. Defaulted municipal bonds tend to be found in riskier sub-sectors, and often are non-investment-grade or non-rated.

Market risk: Municipal bonds, like other fixed income investments, are subject to market risk. Market risk is composed of a number of factors: interest rate risk, price volatility, and liquidity risk. The interest rate of most municipal bonds is set at the time of issue, and the rate does not change over the life of the bond. Therefore, if interest rates in the marketplace rise, the bond already owned is paying a lower yield relative to the yield offered by newly issued bonds. As a result, if a holder of the bond wanted to sell the bond in the secondary market, such a bond would be sold at a lower price than when originally purchased in a lower interest rate environment.

Price volatility is a function of the term and interest rate characteristics of the bond. For all bonds, including municipal bonds, the ability to sell the bond in the secondary market is known as liquidity risk. If an investor intends to hold a municipal bond to maturity, then the investor may be indifferent to interest rate risk.

Municipal Bonds and Diversification

Diversification is a portfolio strategy designed to reduce exposure to any one risk by combining a variety of investments. One way in which personal financial advisors may measure diversification in a portfolio is through correlations between asset returns in the portfolio. In a well-constructed portfolio, advisors will include components that are not all highly correlated with equities, an asset class which often makes up the bulk of the portfolio. Municipal bonds may be a good choice for this diversification purpose since their returns are typically not highly correlated with equity returns. Historical return correlations, however, are no guarantee of future correlation patterns.

Municipal bonds are one of the tools which financial advisors may use to match assets to anticipated liabilities in a portfolio.

Putting It All Together

Understanding the basics of municipal bonds enables an advisor to determine how they might fit into a client's portfolio. Whatever the investment goals, an investment advisor can help the client by explaining the options available and taking into account income needs and tolerance for risk, as well as matching assets like municipal bonds or municipal bond funds against a client's anticipated future liabilities.

*Want to learn more about municipal bonds? Read the next paper, *Fixed Income 201: Municipal Bond Indices and Funds*, available at www.seemoreindices.com/munis.*

Additional Resources

Unlike equities, which trade on open exchanges (NYSE, NASDAQ), municipal bonds trade in an over-the-counter market. The Municipal Securities Rulemaking Board (MSRB) is a regulatory organization in charge of municipal bond securities dealers. The MSRB works closely with the SEC and FINRA to ensure compliance by the dealer community with MSRB rules, including those for fair dealing, disclosure, suitability, and fair pricing.

The MSRB is providing greater transparency to the once opaque municipal bond market through its Electronic Municipal Market Access (EMMA) system. EMMA provides free online access to official statements, continuing disclosures, and real time trade and historic trade data for municipal bonds. More information about the MSRB is available at <http://www.msrb.org/>.

Additional Resources

The Rieger Report Podcast: www.podcasts.standardandpoors.com
S&P Indices Practice Essentials: www.seemore-indices.com/munis
S&P Indices Market Attributes®: www.marketattributes.standardandpoors.com
S&P Indices Thought Leadership Center: www.seemore-indices.com
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