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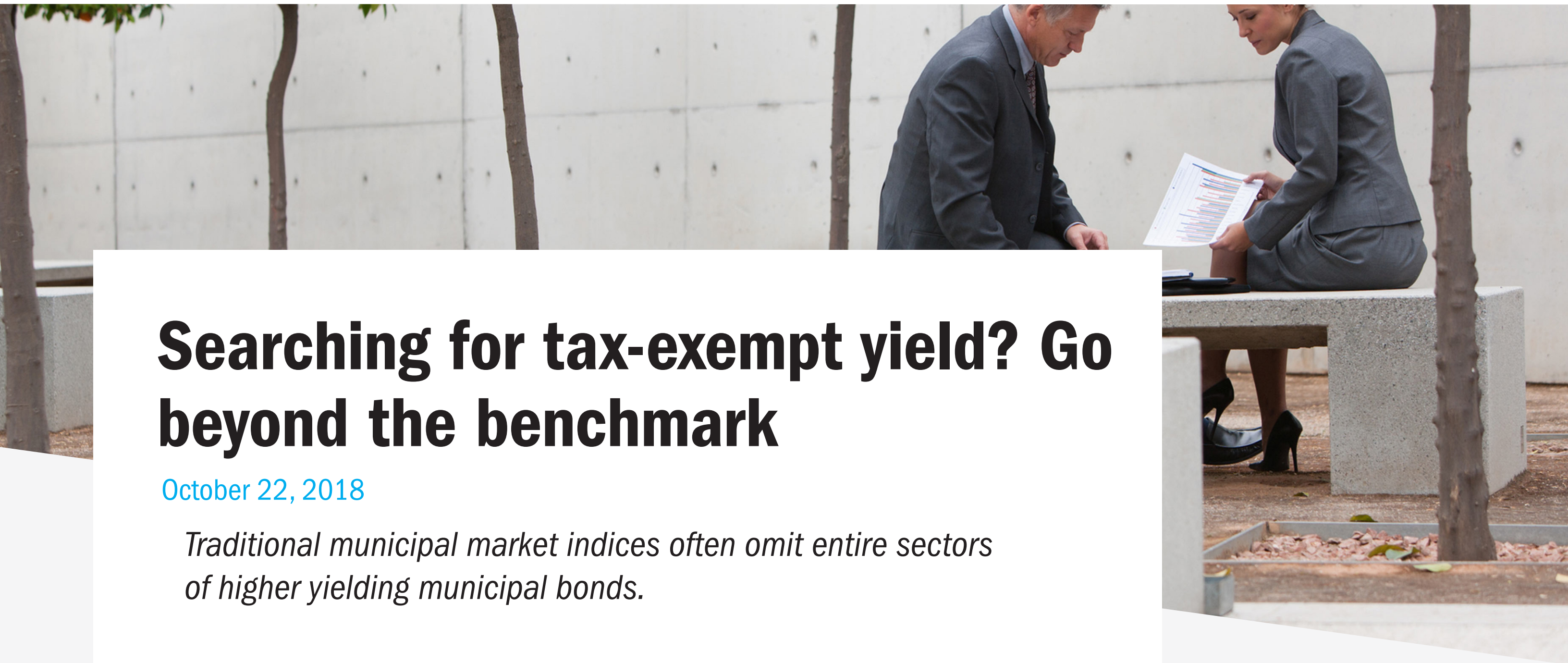

# Searching for tax-exempt yield? Go beyond the benchmark

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*Traditional municipal market indices often omit entire sectors of higher yielding municipal bonds.*

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We recently asked financial advisors about their challenges with municipal bond investing. Their top concern? Finding the right amount of yield to align with their clients' goals. Finding yield is particularly challenging for those who rely on passive products that track traditional benchmarks. The reason? Traditional municipal bond indices can be flawed; they're weighted by debt and exclude viable investment opportunities at the expense of yield. But these flaws can actually present opportunities for investors who choose to take a more strategic approach.

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Key findings:

- The municipal bond market is difficult to define and track broadly.
- Traditional municipal bond indices can be flawed: weighted by debt, exclusive of viable investment opportunities and biased toward quality at the expense of yield.
- These flaws may present opportunities for investors who approach the municipal market with a more strategic approach.

A SMARTER SOLUTION TO MUNICIPAL INVESTING

It's been close to four decades of declining interest rates. Central bank policy rates hitting zero, quantitative easing policies, low inflation and tepid growth drove sovereign bond rates to historic lows. In the municipal bond market, this manifested in yields declining from 13% in 1982 to 2% in 2017.[1] With normalization of central bank monetary policy occurring now, the best case scenario is for rates to remain stubbornly low. However, there is the risk that a new reliance on fiscal stimuli will create budget strains, which could drive inflation and rates higher. Sourcing income and managing potential income volatility in this new rate regime presents unprecedented challenges for fixed-income investors.

Investors looking toward municipal bonds for tax-exempt income may need to consider not only this new rate regime, but how fragmented the muni bond market actually is. They also have to think about how it's changed since the financial crisis, most notably with the dissolution of monoline insurance and certain high-profile municipal bankruptcies. With passively managed vehicles continuing to grow in popularity, we believe investors should consider a more strategic approach to the intricacies of the muni bond market.

The municipal bond market is difficult to define and track broadly

Municipalities have been issuing debt since the early Renaissance when Italian city-states borrowed money from major banking families. American cities have been borrowing since the nineteenth century — records of U.S. municipal bonds indicate use around the early 1800s. The first recorded U.S. municipal bond was issued by the City of New York to construct canals from the Hudson River to Lake Erie and Lake Champlain in 1812. Today, municipal bonds provide public entities with a lower cost mechanism to fund day-to-day operations or finance long-term capital projects.

Indices exist in large part to measure the value of a given market. While stock market indices are very familiar and offer widely accepted benchmarks, several unique intricacies make the municipal market far more difficult to define and track:

- The municipal bond market is composed of $3.9 trillion in market value, which is spread across over 80,000 issuers and roughly one million individual bonds.[2] Any one issuer can have scores of individual bonds outstanding, each providing varying security pledges, maturities, coupons and call structures. The high degree of fragmentation makes it nearly impossible for index providers to replicate the full market opportunity.
- Municipal bonds trade over the counter rather than on a central exchange. Dealers act as market makers by quoting transaction prices for buyers and sellers. Pricing is often influenced by trading frequency or transaction size, both of which can affect transparency and liquidity.
- Unlike the corporate or government bond markets, households own over 41% of all municipal bonds outstanding.[3] Many investors purchase municipal bonds with the intention of holding them to maturity. As a result, many municipal bonds trade infrequently, which makes daily pricing more difficult to calculate.

**Problem: Traditional indices exclude enhanced investment opportunities in the revenue bond sector**

Municipal bonds fall into two primary categories: general obligation (GO) bonds and revenue bonds. **GO bonds** are backed by the full faith and credit of the issuing municipality and reflect a commitment to use all available funds to repay the debt, including the ability to raise taxes.

**Revenue bonds** are secured by the revenue stream generated from the specific income-producing project that's being financed. Sometimes, in transactions known as **conduit** financing, municipalities issue revenue bonds on behalf of private entities that subsequently assume full responsibility for debt repayment. Conduit bonds can be issued by hospitals or health systems, private colleges or universities, or other charitable organizations. Without direct government ties, these bonds may be perceived as carrying greater risk. And this could explain why many traditional indices have significant exclusion rules that primarily target revenue bond sectors.

For example, the S&P National AMT-Free Municipal Bond Index specifically excludes conduit issuers, and the Bloomberg Barclays Municipal Managed Money Index excludes hospitals and housing bonds. These exclusions concentrate exposure in the few remaining sectors that are more explicitly tied to governmental activities: tax-backed, water and sewer, public education and transportation. This approach forfeits access to a broad swath of market opportunity and results in an over-representation of lower yielding general obligation debt.

## Potential opportunity: Revenue bond sectors offer higher yields

In the last decade, several high-profile municipal downfalls, driven by long-term budget mismanagement, have challenged the sanctity of the GO pledge. More importantly, bond investors have found themselves at the mercy of not only a municipality's ability to pay, but of their willingness to do so. Detroit and Stockton, for example, emerged from bankruptcy by making cuts to bondholders while largely preserving pensions for retirees. These examples and other recent experiences suggest that GO debt, often valued for its perceived safety and security, is not immune to impairment.

Despite this, GOs experience persistent demand that drives yields lower than many similarly rated alternatives. Representing nearly 70% of the market, revenue bonds lack the taxing authority of state and local governments and often trade at a discount to their GO counterparts. This represents ample opportunity for investors to pick up incremental income and potentially improve risk-adjusted returns — particularly in housing and hospitals, two sectors often excluded from prevailing indices.

## Bottom line

Not all segments of the municipal market offer the same income opportunities. Investing across sectors can increase yield potential.

**S&P National AMT-Free Municipal Bond Index** is a broad, comprehensive, market value-weighted index designed to measure the performance of the investment-grade tax-exempt US municipal bond market. Bonds issued by US territories, including Puerto Rico, are excluded from this index.

**Bloomberg Barclays Municipal Managed Money Index** is an unmanaged index that is rules-based, market-value weighted engineered for the tax exempt bond market. All bonds in the National Municipal Bond Index must be rated Aa3/AA- or higher by at least two of the following statistical ratings agencies: Moody's, S&P and Fitch.

Income from tax-exempt **municipal bonds** or municipal bond funds may be subject to state and local taxes, and a portion of income may be subject to the federal and/or state alternative minimum tax for certain investors. Federal income tax rules will apply to any capital gains.

**Investing involves risk including the risk of loss of principal.**

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