

# AN INTRODUCTION TO MUNICIPAL BONDS

## What are municipal bonds?

Issued by cities, counties, states, U.S. territories and other entities, municipal bonds are debt instruments mostly used to fund public projects for the betterment of the community. This could include projects such as airports, bridges, hospitals, affordable housing developments, wind farms, power plants, roads, schools, and water and sewer facilities. Interest from municipal bonds is typically free from federal income taxes and/or state and local income taxes, depending on the taxpayer's state of residence.

Municipal bonds provide public entities with a lower cost way to fund day-to-day operations or finance long-term capital projects. With a market value of approximately \$3.9 trillion outstanding, the municipal bond market is quite large with 50,000 issuers and approximately 1 million different bonds.<sup>1</sup> Any one issuer can have scores of individual bonds outstanding, each providing varying security pledges, maturities, coupons and call structures. Municipal bonds are traded over the counter, rather than on a central exchange, and 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.

Relative to corporate and government bonds, in which institutional investors play a dominant role, the municipal bond market is generally considered to be a retail market in which "mom and pop" investors own a significant portion of the bonds. As many investors purchase municipal bonds with the intention of holding them to maturity, they may be traded relatively infrequently, which can make it more difficult to determine a bond's value on a daily basis.

### Reasons to consider municipal bonds:

- 1 Tax-exempt income\*
- 2 Attractive income stream for retirement
- 3 Potential for long-term performance with relatively low volatility in most years
- 4 Investment diversifier away from more traditional asset classes

<b>SECURITY PLEDGE OR COVENANT</b>	A security pledge or covenant is an agreement between a bond issuer and a bondholder. Pledges (covenants) are designed to protect the interests of both parties. They may forbid the issuer from undertaking certain activities or may require the issuer to meet specific requirements or financial targets.
<b>MATURITY DATE</b>	A bond's maturity date is the date when the investor will receive the principal initially invested.
<b>COUPON RATE/ COUPON PAYMENT</b>	A coupon rate represents the interest rate the bond will pay the investor. A coupon payment is the periodic interest payment the bondholder receives between the bond's issuance and maturity.
<b>CALL STRUCTURE</b>	Call structure defines the requirements (such as date and price) that must be met for a callable bond to be redeemed by the issuer prior to its stated maturity date.



To learn more about how this asset class might complement your portfolio, speak with your financial advisor. For additional investor education materials, please visit [investor.columbiathreadneedleus.com](http://investor.columbiathreadneedleus.com).

\*Income from tax-exempt **municipal bonds** or municipal bond funds may be subject to state and local taxes, and a portion of the 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.

**Diversification does not ensure a profit or protect against loss. Past performance is not a guarantee of future results.**

## Types of municipal bonds

The following is a list of the most common types of municipal bonds:

**General obligation (GO) bonds** are debt instruments backed by the full faith and credit of the issuer through its power of taxation. GO bonds have historically been considered one of the safest types of bonds due to the taxing ability of the issuer. State GO bonds are issued by a state, while local GOs are issued by a local municipality.

In recent decades, several high-profile municipal downfalls — largely 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 also their willingness to pay. Detroit and Puerto Rico, for example, emerged from bankruptcy by making significant cuts to bondholders while largely preserving pensions for retirees. These and other examples suggest that GO debt, often valued for its perceived safety, is not immune to impairment. Despite this, GOs typically experience persistent demand that drives yields lower than many similarly rated alternatives.

**Revenue bonds** are typically issued by an entity to finance a project (e.g., toll road, bridge, electric power plant, hospital, housing development, etc.) with the issuer pledging the revenues generated by the project to bondholders. As revenue bond payments are dependent on the financial success of the specific project, they have sometimes been thought to be riskier than GO bonds, which are supported by the issuer's credit and taxing power.

**Taxable municipal bonds** are issued by a municipality but are not tax-exempt because they do not provide a substantial public benefit. Taxable municipal bonds represent approximately 20% of the total value of the municipal bond market. An issuer may issue both tax-exempt and taxable municipal bonds. Examples of taxable municipals include a college dorm, an airport terminal built for the benefit of a specific airline and the Build America Bonds (BABs) of 2009–2010. Because interest payments are taxable to investors, taxable bonds typically offer higher pretax yields than their tax-exempt counterparts. Taxable municipals are popular with institutional investors and non-U.S. investors who do not benefit from a traditional municipal bond's tax exemption and who are looking to further diversify their portfolio into a high-quality asset class.

## Tax-exempt income is a key benefit and significant driver of returns

Interest income is the most significant driver of long-term performance in fixed-income markets. An additional benefit from investing in municipal bonds is their tax exemption. While a municipal bond's interest is typically tax-exempt at the federal level, investors who purchase municipal bonds issued by their state or city of residence may also find the interest exempt from state and local income taxes, providing investors with a double or even triple tax exemption. Because of these tax benefits, interest rates paid by municipal bonds are almost always lower than those of taxable bonds with similar characteristics and credit ratings. To compare the yield of a tax-exempt bond with that of a taxable bond on an apples-to-apples basis, an investor should gross up the municipal bond's interest rate by their income tax rate. This taxable-equivalent yield (TEY) is the pretax yield a taxable bond needs to offer for its yield to be equal to that of a tax-exempt municipal bond. The TEY can help an investor decide whether a tax-exempt municipal bond or a taxable bond is most advantageous, given the relevant income tax bracket.

## Calculating a Municipal Bond's Taxable-Equivalent Yield (TEY)

If a municipal bond's stated yield is 3.50%, and your marginal federal income tax rate is 40.8% (37% federal tax + 3.8% net investment income tax), its TEY is 5.91% ( $3.50\% / (1 - 0.408)$ ). This means that a taxable bond should offer an interest rate higher than 5.07% for it to be more attractive from an income perspective to an investor in the 40.8% federal income tax bracket. If this bond were issued in the state of California for a California resident in the 13.3% marginal state income tax bracket (54.1% federal plus state), the TEY would be 7.63% ( $3.50\% / (1 - 0.541)$ ). Investors in lower tax brackets have lower TEYs and a smaller tax benefit from investing in municipal bonds.

$$\text{TEY} = \frac{\text{Tax-free municipal bond yield}}{(1 - \text{marginal income tax rate})} = \frac{3.50\%}{(1 - 0.408)} = 5.91\%$$

### Bottom line

Investing in municipal bonds can help investors meet their income needs with a tax benefit, reach their short- to long-term investment goals and further diversify their investment portfolio. We recommend that you speak with your financial advisor to learn more about municipal bond investing and how you can strategically benefit from this high-quality asset class and the tax-exempt income it offers within a diversified investment portfolio.

<sup>1</sup> Source: MSRB, 2020.

There are risks associated with **fixed-income** investments, including credit risk, interest rate risk, and prepayment and extension risk. In general, bond prices rise when interest rates fall and vice versa. This effect is usually more pronounced for longer term securities. **Municipal securities** may be affected by tax, legislative, regulatory, demographic or political changes, as well as changes impacting a state's financial, economic or other conditions.

#### **Past performance is not a guarantee of future results.**

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