

# Muni Bonds in a Postapocalyptic World

## Abstract

After US Treasuries and Agencies, Municipal Bonds are perceived to be the next safest asset class.

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***“I am not so much concerned about the return on my money as the return of my money!”***

Will Rogers

***“Finding the best person or the best organization to invest your money is one of the most important financial decisions you'll ever make”***

Bill Gross

***“If you are not aggressive, you not going to make money and if you are not defensive you will not keep your money!”***

Ray Dalio



## Should municipal bonds be part of your investment portfolio?

Risk tolerance and cash flow needs are the primary determinants of the portfolio allocation an investor could/should make to bonds.

Bonds have been used by investors to produce income and preserve capital. Bonds also are considered to have a relatively low correlation to other asset classes which makes them attractive as a diversifying asset. In particular, municipal bonds are an investment that helps to improve local infrastructure, while at the same time providing tax exempt income.

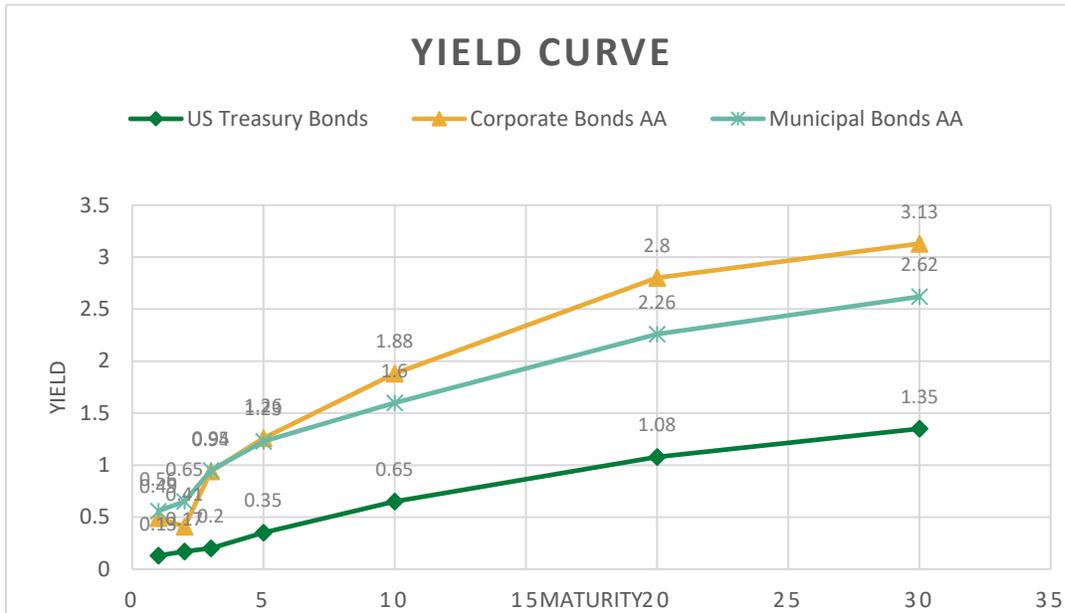
## What are Municipal Bonds?

First, let us discuss the municipal bond market and how it developed. Municipal bonds are debt issued by a state or local municipality to fund public works projects. The size of the municipal bond market has grown to approximately 4 trillion. These are debt instruments issued to raise capital. They are backed by the full faith and credit of the issuer. There are two types of municipal bonds: General Obligation and Revenue. General Obligation bonds for many years were considered slightly safer

than Revenue bonds as the issuer is able use its full taxing power to meet debt. Whereas a Revenue bond is backed by a specific infrastructure project's cash flow. Revenue bonds make up about 65% of the municipal market. Revenue bonds have gained in popularity recently as a result of the relatively poor financial condition of many state and local balance sheets. Different from other bonds i.e. corporates, treasuries, and mortgage backed, the interest on a municipal bond is usually federal tax free, and in some cases, state and local tax free.



## So why Municipal Bonds?



For the purpose of this paper we will assume that we are discussing a taxable portfolio. In looking at the above yield curve chart, purchasing municipal bonds over US Treasuries seems to make sense in this low interest rate environment. If you are comfortable with the credit quality of the municipality you can pick up better than 100 basis points in the 10-year bucket. The nominal rate on treasury 10-year yield of .65% is inferior to the AA municipal yield of 1.6%. But what about the same AA rated corporate bond yielding 1.88%? To answer that question, we have to take a look at the tax advantages of the Muni bond in comparison to the taxable corporate bond.

### Tax Efficient Income

The 1913 Tax code created the federal tax exemption for municipal bonds under the principle of reciprocal immunity. Understanding the tax equivalent yield of a municipal bond compared to a taxable bond is the first step in analyzing whether it is better to invest in municipal bonds versus other instruments. For someone in the highest tax bracket of 37% the formula to compare taxable to tax equivalent yields of a municipal bond is:

$$\text{YIELD}/(100\%-37\%) = \text{TEY}$$

So, an example would be a municipal AA muni 10 year yielding 1.6%

$$1.6\%/ .67\% = 2.38\%, \text{ the current AA Corp yields } 1.88\%,$$

**Add in the Net Investment Income tax of 3.8%.** *The net investment income tax is a 3.8% surtax on a portion of your modified adjusted gross income over the following thresholds and have net investment income: single \$200,000, married filing jointly \$250,000 and married filing separately \$125,000.*

$$\text{YIELD}/(100-(37\%+3.8\%))=2.7\%$$

From the above example, there would be an advantage to holding the Muni Bond over the other securities. As a matter of fact, for someone in the 22% tax bracket, the tax equivalent yield would be 2.05% for the muni bond in the example. Municipal bonds interest is exempt from the Net Investment Income Tax. Usually a bond issued in one's state is exempt from state and local income tax which can add up for those in a high tax bracket state such as California, Massachusetts, New York, New Jersey, Ohio etc. Consider California for an example, where the highest bracket is 13.3%. The yield would look like this:

$$\text{Yield}/(100\%-(37\%+13.3\%+3.8\%))=\text{TEY}$$

$$1.6\%/ .459\%= 3.55\%$$

After considering the tax advantages of the Muni bond, it has become clear that the Muni bond yielding only 1.6% is far better (for most tax brackets) than a corporate bond yielding 1.88%. In fact the corporate bond would need to yield almost 3.55% to equal the after-tax value of the Muni bond.

Due to the tax efficiencies of Muni bonds, as well as the 2017 Tax Reform and Jobs Act, demand for muni bonds has increased in high tax states. The Tax Reform and Jobs Act created less tax write-offs and thus more demand for tax free income.

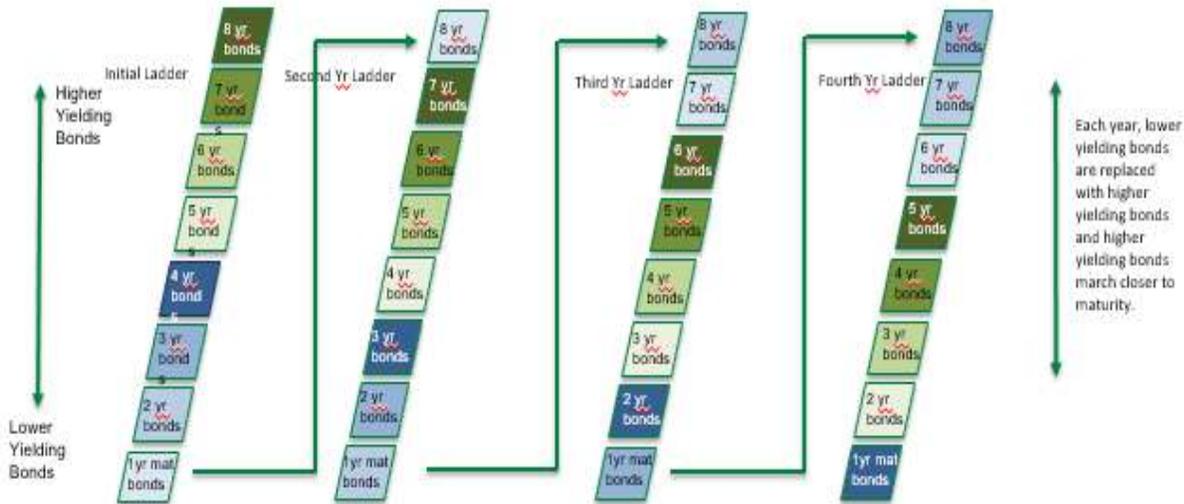
### **Muni Bonds have Low Default Rates!**

Investors view US Treasuries as a riskless investment. After US Treasuries and Agencies, municipal bonds are perceived to be the next safest asset class. Moody's investors service conducted a study from 1970 to 2018 and on a rolling 10year average the investment grade muni bond default rate was .10% versus that of corporate bonds of 2.28%. Also, consider that 30 years ago, 60 US companies were rated AAA, today there are 2. Currently there are 13 states that are rated AAA, 34 rated AA, and only 3 states rated below AA. There are plenty of local municipalities rated AAA.

Sometimes investors would overlook credit risks because most of the muni bonds are insured. In 2007, prior to the Financial Crisis, 7 of the 10 municipal bond insurers were rated AAA and 57% of new issued bonds carried insurance from these companies. After the Financial crisis, all the insurers were stripped of their AAA rating due to their exposure and losses associated to the mortgage backed market. Many have merged or gone out of business and today only about 6% of bonds are insured. So, choosing a muni bond has become more difficult and requires research.

## Is the Best way to Invest in Bonds to use the Ladder Approach?

Prior to the Financial Crisis in 2008, laddering the bond portfolio was considered a diversified and interest rate neutral investment approach to fixed income. This was especially true for municipal bonds. Investors would purchase bonds from 1 year to 10 years, reinvesting the maturing bond at the



farthest point of the ladder. The ladder approach works well when the yield curve is positively sloped (the vast majority of the time). One disadvantage of the laddering method is that it forgoes the opportunity to concentrate on sectors of the yield curve that offer great value. Using the ladder method is also more aligned to passive investing by keeping your portfolio maturity/duration risk constant.

## Key Components of Bond Investing

While examining the tax equivalent yield is important, credit selection is the number one factor in building a solid bond allocation. The key to credit selection is understanding the bonds and the issuer. Despite the fact that the default rate on municipal bonds is extremely low, many municipalities are facing pension and legacy costs, greater budget deficits, and demographic shifts. The municipal bond market trades over the counter, meaning there is no central exchange. Central exchanges, such as the New York Stock Exchange, or the Chicago Mercantile Exchange are designed so investors experience greater liquidity and no counterparty risks. (Counterparty risk is the risk you take when you trade directly (not through an exchange) with another person or entity. You assume the risk that maybe that entity won't fulfill the terms of the deal.) Since municipal bonds trade off exchanges (over the counter), credit research becomes critical, and a professional manager is usually needed to discover inefficiencies and assure proper yield curve positioning.

The second key component of bond investing is selecting the best maturities. In a recent Warren Financial white paper entitled, "The Role of Bonds in a Portfolio while Interest Rates are Low", we discussed a barbell strategy when selecting bond maturities. In the current environment with some

dislocation in the fixed income markets the maturity selection can be quite important. So, research and expertise are major considerations.

As a general rule for bond investing, keep in mind diversification. It is wise to hold bonds from various states and not over-concentrate. Finally, when purchasing bonds, there is a school of thought that taxable bonds are better held in a tax deferred account such as an IRA, as the interest is taxed at the ordinary income rate, but that may not always be possible.

## Summary

Municipal bonds have several advantages in a taxable portfolio including (a) interest that is generally tax free on the federal level, (b) low correlation to other investments and (c) low default rates. Investors in the 22% tax bracket or higher may find municipal bonds to be favorable compared to other taxable fixed income investments. Other than US Treasury bonds the fixed income/bonds landscape has become more complex. It is imperative that investors research the credit quality and understand the particulars of the bond and the issuer whether it is a muni, corporate, or mortgage backed security. Laddering your bond portfolio is a form of passive management which reduces the need to manage interest rate exposure. In this low interest rate environment it may be wise to hire a professional manager that has the capability to do the required research and has the ability to add value by taking advantage of the inefficiencies in the municipal yield curve as well as the difference in yield between municipal bonds and other fixed Income securities.

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