



The Case for Investing in Municipal Bonds

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Once again, we are hearing that municipal bonds (i.e., bonds issued by local and state governments) may not be safe, given the dire finances of many towns and cities and “strategic defaults” in several municipalities. We are also hearing that upcoming tax reform may trim, if not eliminate, the tax-free status of all municipal bonds.

Should you be worried? No. In this note, we seek to provide you with some data and perspective as to why we believe municipal bonds remain a good investment, and, frankly, why they are an excellent substitute for holding cash in a low-yield environment.

There is no doubt that the dynamics of the municipal bond market have changed in the last few years. In particular, the dramatic decline in the number of AAA-rated municipal insurers after the financial crisis helped lower the share of AAA-rated bonds in the municipal universe from 75% to 13% today. At the same time, many cities and states have been struggling with unfunded pension liabilities, declining tax receipts, and declining support from the federal government. For these reasons, municipal bonds seem to be, on average, riskier than they were just a few years ago.

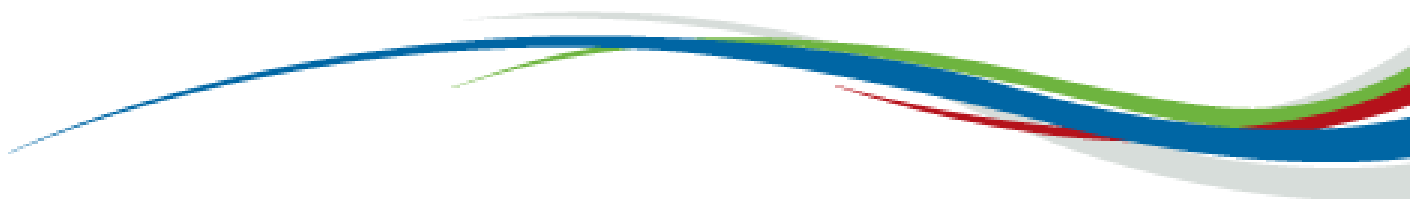
Yet default rates for traditional, well-secured municipal bonds remain very low. For example, only \$107 million in general obligation water/sewer

bonds, and dedicated tax bonds have gone into payment default in 2012 so far (data through August). This represents 0.8% of all municipal defaults and a mere .004% of state and local debt outstanding. Historically, too, default rates have been extremely low: From 1970 to 2011, only 71 municipal issuers rated by Moody’s Investors Service defaulted on their debt.

This impressive record is in part due to the fact that, unlike our federal debt, municipal debt levels are actually declining as a percentage of U.S. GDP, and many local and state governments are exhibiting better liquidity than in previous downturns. Among high-grade issuers, annual debt costs remain well within historical norms, and annual principal and interest costs remain a small portion (less than 10%) of annual municipal spending.

Not All Bonds are Equal

Investors also should remember that the municipal market is not homogeneous – some types of bonds are indeed much safer than others. In general, higher-quality bonds include general obligation bonds, which are secured by the authority of the issuer to levy taxes to repay bondholders. Revenue bonds (bonds that are secured by a specific revenue source) for essential public projects are also considered very safe because municipalities have a consistent need to finance vital public infrastructure, and laws require payment on these bonds except in extreme financial emergencies.



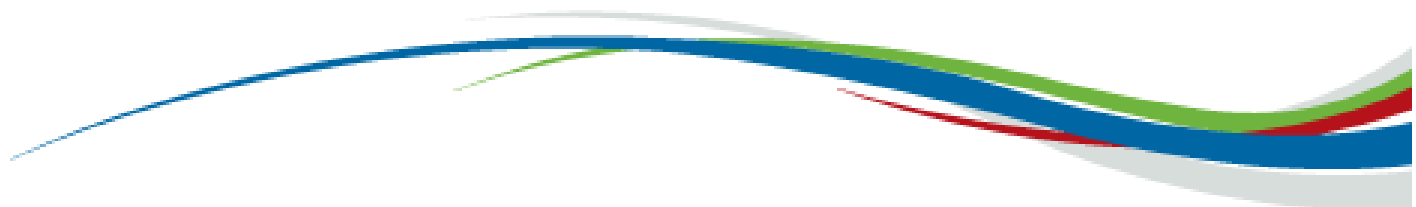
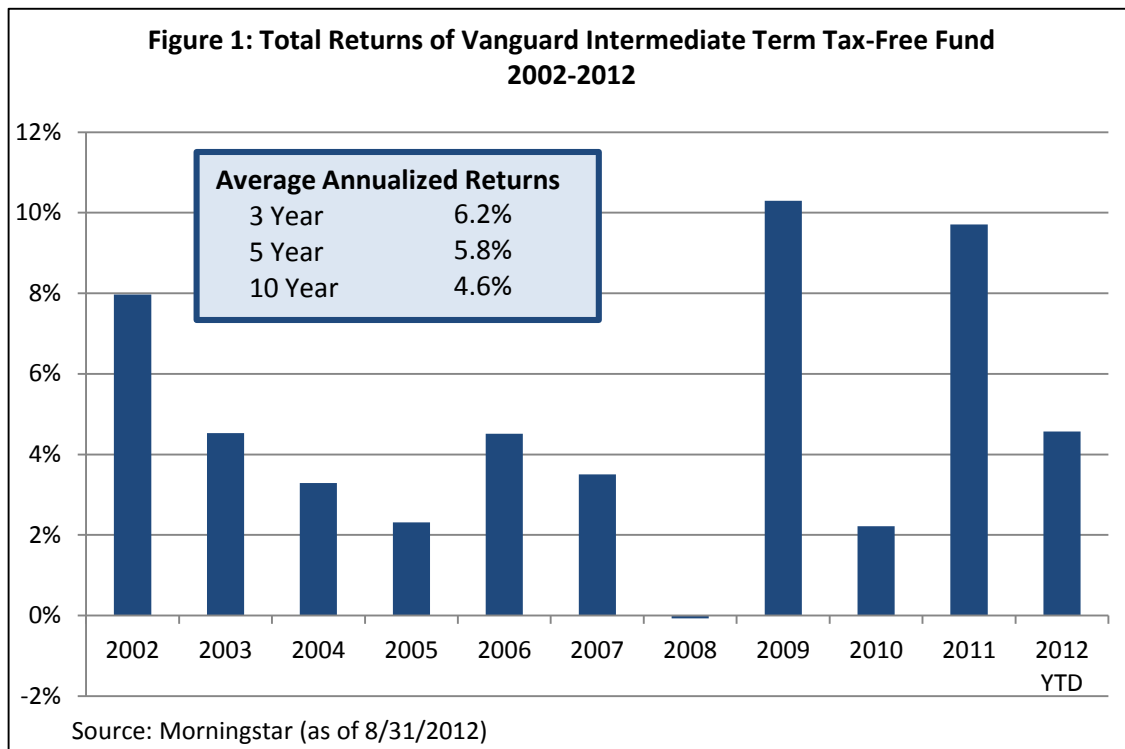
As in past recessions, today's defaulters are reneging mostly on poorly secured bonds issued for non-essential projects (sports stadiums, alternative energy projects, and so on). For example, Stockton, CA, and Moberly, MO, have sought to restructure poorly secured pension-obligation and economic-development bonds. Even those cities are not impairing repayment of water utility or general obligation debt.

As a result, high-quality municipal bonds have delivered very steady returns over the past decade. Figure 1 shows the annual returns of the largest investment-grade, intermediate-term tax-free bond fund in the U.S. managed by Vanguard. This fund maintains a high-quality focus and has very low volatility. Only in 2008 did the fund have a very slight negative return of -0.07%. With a 10-year annualized tax-free return averaging 4.6% (as of August 31, 2012), or a taxable equivalent return of 7.1% (assuming a 35% tax bracket),

municipal bonds are, in our view, an excellent substitute for cash for high-income earners. For investors who want something even safer, a shorter-term municipal fund will typically provide a lower total return but with even less volatility.

Federal Tax Reform's Possible Impact on Muni Bonds

But what about tax reform? President Obama's 2013 budget proposal includes a 28% cap on the exemption for municipal bond income for families with income of more than \$250,000. This means that investors in the maximum 35% tax bracket would end up paying an effective rate of 7% on municipal interest income, or 11.6% if the Bush tax cuts expire at year end. This only marginally reduces the attractiveness in municipal bonds in our view, especially in light of the fact that municipal bond income is exempt from the new 3.8% Medicare tax scheduled to take effect on January 1, 2013.



Some budget analysts suggest that the tax-advantaged status of municipal bonds might be removed entirely. Though this would be worrisome, there are several reasons why we do not believe this is a likely outcome. First, essentially all mayors, county officials, and governors have a strong interest in retaining the tax exemption on municipals and the political clout to fight hard for their interests. Moreover, with the federal government still strongly committed to stimulating economic activity and stemming job losses, it is unlikely Congress is going to prioritize raising borrowing costs for municipal issuers. In addition, the benefit of eliminating the tax exemption on municipal bonds is

relatively small in comparison to other revenue options on the table (see Figure 2).

Bottom Line

Municipal bonds continue to make sense for many investors in high tax brackets. Moreover, the new Medicare tax and expiring Bush-era tax cuts may well stimulate demand for municipal bonds, as high-tax-bracket investors seek tax-advantaged solutions. In today's world, with inflation running at 2%, and yields on cash effectively zero, the only thing guaranteed by holding a lot of cash is loss of purchasing power. Municipal bond investing remains a reasonable alternative.

Exclusion of employer health care contributions	184
Deductibility of mortgage interest on owner-occupied homes	99
Capital gains (including home sales)	76
Tax deferral on 401k plans	68
Treatment of capital gains at death	61
Exclusion of net imputed rental income	51
Deductibility of state and local taxes	49
Employer provided pension contributions	45
Deductibility of charitable contributions	43
Exclusion of interest on municipal bonds	37

Source: Fidelity/Analytical Perspectives

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