Taking Inventory of Municipal Bonds

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June 25, 2015

Municipal bonds have long provided a tax-advantaged investment option for those in higher tax brackets. Their exemption from federal, and often state and local taxes, makes them attractive on a taxable equivalent basis to other fixed income options. However, municipal bonds can be used by investors in any tax bracket to offer a solid, relatively safe by historical standards, return. Municipals currently offer a superior return to Treasuries and help you manage the risk of your aggregate portfolio by incorporating debt of states and municipalities. Furthermore, as income tax rates have increased for many in this country due to Obamacare, the investment income surcharge and hikes in Medicare payroll taxes, muni bonds have become especially appealing.

That Appeal – The allure of municipal bonds has not been lost on investors as the sector has enjoyed a sustained rally. In our low interest rate environment, rates on longer-term debt issued by U.S. states, cities and municipalities looked appetizing vs. Treasuries, especially on a tax-adjusted basis. According to Barclays, the sector was up 9% in 2014 on a total return basis.

Current Environment - Looming concerns about interest rate increases by the Fed have torpedoed the bond market thus far in 2015, and municipals have been no exception. June is on track to bring home the third month of price declines. Lingering concerns about the Puerto Rico debt refinance, continued troubles in Illinois and heavy debt issuance by municipalities have propelled yields higher. The upside for investors is that they can now pick up greater return from municipals than their taxable equivalents, even before the tax adjustment. Buy a 15 year triple A rated muni and pick up 20 basis points in yield over a comparable Treasury. The further down the credit curve you move, the greater the pick-up.

Taxable Portfolio Strategy - As dividends and capital gains are taxed at a lower rate than interest, we usually advise clients to hold, to the extent possible, equity in taxable accounts and fixed income in tax-deferred accounts. Should fixed income be held in the taxable, we recommend municipal debt to bring down the tax liability.

Tax-Deferred Portfolio Strategy – Even in a tax deferred portfolio, municipals can play a valuable role. We advocate placing higher yielding taxable municipals in IRAs, Roths and other tax-deferred accounts. Taxable municipal bonds are often issued to finance a project that does not provide a major benefit to the general public, such as a stadium. As such, the federal government will not provide the tax-exemption. Taxable municipals often have a higher yield than Treasuries, agency bonds and corporates.

Individual Bonds vs. Funds– When purchasing an individual bond you know exactly – absent default – what you will get back at maturity. When bond funds are purchased, capital gains

and losses are often outside of your control, determined by the portfolio manager or redemptions of the funds. That being said, it is often difficult to gauge the long-term credit risk of an issuer without substantial research or to buy enough bonds to offer diversification. We recommend sticking with high quality municipal bonds with maturities timed to meet your cash needs. This mitigates credit risk and capital gains surprises. Should you go the fund route, choose a well-diversified and high credit quality fund.

Diversify Your Holdings – The grand mantra of investing should apply to your municipal bond portfolio as well; buy a basket of diversified geographies and issuing entities. While there are concerns about Illinois, Puerto Rico, New Jersey, and California, other states are enjoying a strong economic climate. Balance the higher yields you will receive from California with the lower rates of thriving Virginia, North Carolina, and Georgia.

Watch the Headlines for Credit Issues – The Detroit news of past has now been replaced with concerns about Chicago, the State of Illinois, and Puerto Rico. Chicago debt was downgraded below investment grade status by Moody's in May, most notably because of the city's public pension dilemma. Yields on credits of these entities have risen dramatically as a result of the news.

General Obligation (GOs) and Basic Service Bonds Appeal – Consider GOs, which are backed by the full taxing authority of the issuing municipality, and bonds tied to basic services such as water and sewer services. For GO's, the issuing municipality has the ability to levy additional taxes to pay the bond interest. These bonds are considered the safest. Revenue bonds are usually structured to finance a particular project such as a stadium or highway, and coupon payments are dependent on the revenue being generated by the completed project. For revenue bonds used to finance basic utilities such as wastewater treatment, keeping clean water running is often a priority for consumers and towns so revenue streams are generally secure. However, revenue bonds tied to stadiums are the most economically sensitive as attendance may suffer in a downturn. Private purpose bonds such as these are also subject to the Alternative Minimum Tax (AMT).

Don't Feel Compelled to Support Your Home State – Bonds issued by your domiciled state have the advantage of being triple tax-exempt – from federal, state, and local taxes. However, the tax savings may not be worth the risk should something go wrong. We don't advocate a resident of California loading up on debt in that state. Bonds from states without income tax, such as Florida and Texas, often yield more as an enticement to out of state investors. In addition, U.S. territories such as Puerto Rico and the Virgin Islands historically have also offered debt free from any state or local taxes. However, Puerto Rico is one of the headline news credits right now.

Is Bond Insurance Really Worth It? – If you go to buy a Chicago bond today, you may see an AA rating assigned to it as a result of the insurance supporting the issue. Major bond insurance companies are AGC, AMBAC, and MBIA. These companies insure over $72B of Puerto Rico's current debt outstanding. It is reasonable for investors to question how valuable this insurance is and the likelihood of payout given the sheer size of the troubled debt market. Before the 2008 financial crisis, roughly 50% of new municipal bonds carried insurance, mostly so issuers could get lower interest rates. However as the insurers faced losses on mortgage-backed securities

during the crisis, that figure fell. In 2014, only 6% of new municipal issues carried insurance. A recent study by the Kroll Rating Agency identified 29 cases of insured municipal bond defaults from 2008 to present, and found full insurance payment in 26 of the cases. So while the actual record on insurers making investors whole is better than the public perception, the coverage should not be viewed as an absolute guarantee.

Closed-End Funds (CEFs) Offer Attractive Value – Consider adding CEF's to your bond portfolio. These funds employ leverage in their structure and also trade at significant discounts – often 10% or more – to the net asset value of the holdings of the fund. Investors can benefit not only from collecting the attractive yield but also from any price appreciation that results.