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SEC's Investor Advocate Talks Municipal Bonds.

The U.S. Securities and Exchange Commission's Investor Advocate Rick Fleming recently gave a speech discussing the state of the the municipal securities market.

Fleming noted approximately 41 percent of municipal bonds are owned by individual investors, while another 29 percent are owned by investors indirectly through mutual funds or other pooled investments.

However, there are some "disturbing" patterns beginning to emerge. Specifically, Fleming noted a "mere" 2.4 percent of households hold any form of municipal debt, which is half of what it was in 1998. On the other hand, the "wealthiest households" own an "increasing share" of total municipal debt, as the top one-half percent of U.S. households own 42 percent of all municipal bonds.

"Given the favorable income tax treatment of muni bonds, households in higher tax brackets have always had more incentive to invest in muni bonds — this is not news to this audience," Fleming continued. "However, the shift from defined benefit pension plans to defined contribution retirement plans seems [sic.] to have significantly deteriorated the incentive for less wealthy persons to invest in munis."

Naturally, interest on municipal bonds is exempt from federal income tax, and in many cases, state and local taxes. However, the yield on municipal bonds is often less than other taxable fixed-income securities.

The lower yield could be attractive for certain investors but it does lose its appeal within the context of a tax-advantaged retirement account where all holdings are tax-deferred. As such, it makes "little sense" for investors to hold tax-exempt municipal bonds in an IRA, 401(k) or 403(b).

This leads Fleming to question if the tax benefits of municipal bonds designed to encourage investment dollars are actually accomplishing the objective.

"Competing tax policies that favor retirement savings may actually drive most investors away from muni bonds, given their traditionally lower yields," Fleming expanded. "But whatever the cause, if the current trends continue and we see fewer and fewer investors holding an ever-larger proportion of muni bonds, the traditional retail-oriented muni market will change dramatically in the not-to--distant future."

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