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Why Invest In Taxable Municipal Securities?

A taxable municipal bond is a non-tax-exempt fixed-income security issued by a local government to finance projects that the federal government will not subsidize. In this article we explain what taxable municipal securities are, why you should invest in them and how they fit into your portfolio.

What are taxable municipal securities?

Taxable municipal bonds are debt securities issued by states, cities, counties, and other governmental entities, often to finance a project or activity that may directly or indirectly benefit private industry. They differ from tax-exempt municipal bonds in that they are subject to federal tax; Internal Revenue Service rules disqualify municipal bonds from eligibility for federal tax exemption if there is a substantial private use or benefit associated with the bond issue. However, taxable municipal bond issues are often exempt from state and local taxes, meaning that investors who purchase bonds issued within their home state will receive interest income that is only taxable at the federal level. Compared to US Treasuries or tax-exempt municipal securities, these generally offer a higher yield. Bond proceeds are often used to finance industrial development or to improve public pension funding levels. Bear in mind that the Tax Cuts and Jobs Act (TCJA) of 2017 eliminated advance refunding of municipal bond issues on a tax-exempt basis. [1]

Taxable municipal bonds are popular among investors who cannot take advantage of federal tax exemption. These investors include pension funds and foreign investors.

Why invest in taxable municipal securities?

Taxable munis appeal to fixed income investors for a variety of reasons. First, they are perceived to be safer than other taxable alternatives. When one considers the 10- year cumulative default rate of investment grade municipal securities (0.09%) against global corporate bonds (2.23%) with comparable credit ratings, municipal bonds are a safer asset class when protecting against issuer default, according to Moody’s.

Second, taxable municipal securities often provide more attractive yields than many global bonds and other corporate debt. For example, the average yield on the 10- year AAA rated taxable muni was 2.9% over the past several years. By comparison, yields on many sovereign bonds with comparable maturity remained at much lower levels over the same time frame. On average, Japanese and German 10-year government debt yields were 0.09% and 0.43%, respectively.

At the same time, AA taxable munis often provide incremental yield pickup vis-à-vis investment grade corporate debt with comparable credit ratings.

Third, for US investors, some taxable municipal issues are exempt from state and local taxes within the state of issuance. For investors who reside in states that impose a high personal income tax rate such as California, New York, and New Jersey, the state and local tax advantage associated with taxable munis can be noteworthy.

How do taxable municipal securities fit into your portfolio?

Taxable municipal bonds are appealing to investors seeking an incremental yield opportunity while maintaining a strong credit rating. They are also attractive for tax-deferred investment accounts such as IRAs, 401(k)s, and pension funds, where tax-exempt municipal bonds are less appropriate. Additionally, these bonds have attracted demand from foreign investors who traditionally did not invest in municipal securities because they could not reap the tax benefits. Based on the Federal Reserve Flow of Funds data, foreign buyers increased municipal holdings from the end of 2013 (USD 73.8bn) through 2021 (USD 118.7bn), before falling back a bit to USD 108.4bn by 2Q23, reflecting a volatile rate environment.

The taxable municipal market comprises bonds with longer duration when compared to corporate bonds. Examining the maturity distribution of a basket of taxable munis shows that almost 50% come due at the 15-year maturity and beyond. By comparison, only about 25% of an investment grade corporate index includes longer-dated bonds. As a consequence, the taxable muni sector can provide opportunities to add duration or match long-dated liabilities within an overall wealth management strategy.

What are some of the key risks?

The taxable muni market is less liquid than either the corporate bond market or the market for sovereign securities. Also, when purchasing taxable munis as with other fixed income investments, a thorough understanding of early call risk is necessary. Make sure to read the full report for further information on risks.

For ongoing developments in the taxable municipal bond market, please see our monthly report, *Fixed Income Strategist*.

by UBS Editorial Team

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