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SIFMA: Municipal Bonds - Risky Business?

Why invest in the $3.7 trillion municipal bond market? Tax exemption, low default risk, and an investment that lends money to state and local governments to build roads, schools, and hospitals, among other essential needs, are among some of the compelling reasons. And the returns: the average weekly value of the Bond Buyer 20-bond GO Index over the last 20 years (1993-2012) is 5.0%. Generally, municipal bond investors' interest income is exempt from taxation, so for an investor in the 35% federal tax bracket and with a 5% state income tax buying in-state bonds, that 5.0% translates into a taxable equivalent yield of 8.3%, a very attractive return for so little credit risk. Now in 2013, with the 39.6% federal bracket back in place and a new tax on investments in effect, the value of tax-exempt interest is even larger.

As with any investment, however, investors need to weigh the risks against the returns and determine if a particular investment meets their specific needs. To be sure, one of the primary concerns of investors in any "fixed-income" instruments like municipal bonds is the effect of rising interest rates on a bond's market value.

Some investors may be concerned that a spike in interest rates could mean losses for municipal bond investors. In the bond markets, prices move inversely to interest rates. If rates spike, investors would see their bonds' market values drop.   Bond funds are typically active traders of bonds and their assets are also marked to market daily, so market values in these funds would fluctuate with interest rates. The measurement of the sensitivity of a bond's price to changes in interest rates is known as "duration," and duration generally is higher for longer-term bonds.

For buy and hold investors in individual bonds, this won't matter, as they will continue to receive principal and interest payments as they come due, and their bonds will generally mature at par. Investors who don't plan to hold a bond until maturity need to weigh the risks and rewards of investing in a particular bond given their investment time horizon. A very low interest rate environment leaves little to no room for interest rates to fall further, but plenty of room for rates to rise. How quickly that may happen and how the market may react are important pieces of the overall investment picture. The Financial Industry Regulatory Authority, or FINRA, recently issued a useful report outlining considerations for bond investors in low interest rate environments like the current one.

Moreover, many investors have been staying out of the fixed income markets because of the currently low market yields or the fear of rising rates. Households hold far more of their assets in bank deposits, money market funds and other "cash-like" investments which currently yield close to 0% than they do in municipal bonds. When interest rates do finally go back up, investors' cash holdings will yield more, and some investors may be incented to return to the bond markets. Still, investors should consider duration risk as an element of examining investment alternatives.

Amid the concerns, this basic fact bears repeating: issuers of municipal bonds have an outstanding record of meeting interest and principal payments in a timely manner. The long-term default rate for rated, investment-grade municipal securities is 0.15%. Unless the credit picture for state and local governments changes in an unexpected and fundamental way, investors who hold their bonds to maturity have a very high likelihood of seeing their investment perform just as expected.

In the interest rate discussion, it should not be lost that this is the best time in generations for state and local governments to borrow money and issue bonds to fund infrastructure and other important projects. Year to date municipal bond issuance through the end of March was 4.8% higher than issuance in the first three months of 2012, and issuance for the full year 2012 was over 28% higher than issuance in 2011. That's good for our municipalities and the people who live – and work – in them.

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