The Overlooked Benefits of Muni Bonds

Investing Ideas

Municipal bonds are highly liquid, low-volatility investments that can provide ballast for investor portfolios while shielding their income from avoidable tax consequences. But when evaluating their returns, make sure you're accounting for the tax benefit and making an apples-to-apples comparison.

Munis have long been a solid investment choice for investors seeking wealth preservation and steady income. Specifically, investment-grade munis have offered clients access to high-quality debt with lower default rates relative to other bonds. However, while munis are a familiar asset class, their most attractive features are often understated or overlooked.

We believe the tax exemption of the income is the most important benefit of municipal bonds. While many investors understand the concept of tax-free income, the stark contrast between the after-tax returns of taxable and tax-exempt bonds isn't fully appreciated.

Doing the Math

For starters, you have to know the tax-equivalent yield to make a true apples-to-apples comparison. The calculation is different for every investor because it depends on their tax bracket and where they live. Your marginal tax rate is the percentage tax rate that you pay on your last dollar of taxable income. It's typically higher than or equal to your average tax rate.

If you are in the higher tax brackets and subject to phaseout rules that reduce itemized deductions and personal exemptions, your real marginal rate may be a percentage or two higher than the stated percentage bracket. The math is simple:

Tax-Equivalent Yield = Tax-Exempt Yield / (1- Tax Rate)

Yield	Tax Bracket 22%	24%	32%	35%	37%	37% + 3.8% Healthcare Surcharge
1%	1.28%	1.32%	1.47%	1.54%	1.59%	1.68%
2%	2.56%	2.63%	2.94%	3.08%	3.17%	3.37%
3%	3.85%	3.95%	4.41%	4.62%	4.76%	5.06%
4%	5.13%	5.26%	5.88%	6.15%	6.25%	6.75%
5%	6.41%	6.58%	7.35%	7.69%	7.94%	8.44%

Source: Bloomberg and OAM Research

Tax Shield
A comparison of bond index returns before and after taxes over the past 10 years.

	1-Year	5-Year	10-Year
BOA/ML 1-12 Year Muni Return Not Adjusted for Tax Exemption	1.50%	1.99%	2.85%
BOA/ML 1-12 Year Muni Return Income Adjusted for 32% Tax Bracket	3.52%	3.99%	4.88%
BOA/ML 1-12 Year Muni Return Income Adjusted for 37% Tax Bracket	4.02%	4.48%	5.38%
Bloomberg Intermediate Aggregate Taxable Index	0.92%	2.09%	3.13%

Source: Bloomberg

Living in New York and California comes with a pretty hefty price tag in terms of cost of living and the percentage of your wages that are taxed. The Tax Cuts and Jobs Act imposed a $10,000 cap on state and local tax (SALT) deductions, which translates into a higher tax bill for high-net-worth residents. For many U.S. households, that ceiling will outweigh any potential benefits from other tax reforms. High-tax state residents would benefit from investing in home state munis. In addition to the tax shield, municipal bonds have a diversified issuance mix and strong credit profiles in states like New York and California.

4 Key Reasons to Invest in Munis

1 **Low default rate.** From 1970 to 2015, there were only 99 defaults among municipal bonds—an annual default rate of 0.09%--for all-rated municipal bonds throughout the 46-year period, according to Moody's. In fact, investment grade "Aaa" and "Aa" rated munis had no defaults during this period.

2 **High quality.** Municipal bonds are considered to be of a higher quality than other bonds due to the nature of the assets and the pledge backing the securities. Nearly 94% of the $3.8 trillion in outstanding municipal debt is rated investment grade (BBB or higher), with 72% or $2.7 billion rated even higher at AA or AAA, according to Standard & Poor's.

3 **Low volatility.** When adjusted for taxes, muni returns have been in line with stock returns with about half of the volatility, according to FactSet.

4 **Low correlation.** Over the past 10 years, investment-grade municipal bonds have exhibited a negative correlation (-0.12) to the S&P 500, according to Zephyr.

How to Gain Exposure
We offer three tax-exempt fixed income portfolios in a separately managed account to provide a tax-efficient, low-risk portfolio that will complement riskier investments, including two state-specific portfolios: Tax Exempt General Market, Tax Exempt California and Tax Exempt New York.

Key Attributes
- A conservative "core" approach with strong risk controls focusing on total return and preservation of principal
- The investment process begins with an understanding of our clients' unique long-term needs and individual objectives
- Focus on intermediate sector in an effort to optimize risk/return trade-off

If you would like to learn more about our tax-exempt fixed-income strategies or get expert commentary, please contact your Oppenheimer financial advisor.

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Tax-exempt municipal bonds are issued by state and local governments as well as other governmental entities to fund projects such as building highways, hospitals, schools, and sewer systems. Interest on these bonds is generally exempt from federal taxation and may also be free of state and local taxes for investors residing in the state and/or locality where the bonds were issued. However, bonds may be subject to federal alternative minimum tax (AMT), and profits and losses on bonds may be subject to capital gains tax treatment. Municipal securities may lose their tax-exempt status if certain legal requirements are not met, or if tax laws change. The financial condition of the issuer may change over time and it is important to monitor the changes because they may affect the ability of the issuer to meet its financial obligations.

The MSRB's EMMA website (www.emma.msrb.org allows investors to sign up to receive alerts about the availability of important information that may affect their municipal bonds. The MSRB makes official statements and continuing disclosures submitted to it by issuers and others available to the public for free through its EMMA website. EMMA also provides municipal securities trade price information through its Real-time Transaction Reporting System ("RTRS") and free public access to certain municipal credit ratings. See more at: http://www.finra.org/investors/alerts/municipal-bonds_important-considerations-individual-investors#sthash.snkM0mxf.dpuf

Special Risks of Fixed Income Securities: There is a risk that the price of these securities will go down as interest rates rise. Another risk of fixed income securities is credit risk, which is the risk that an issuer of a bond will not be able to make principal and interest payments on time. Liquidity risk refers to the risk that investors won't find an active market for a bond, potentially preventing them from buying or selling when they want and obtaining a certain price for the bond. Many investors buy bonds to hold them rather than to trade them, so the market for a particular bond or a small position in a bond may not be especially liquid and quoted prices for the same bond may differ.