INVESTING IN MUNICIPAL BONDS

Municipal bonds, also known as “munis,” are a type of debt issued by state, local and other government entities to fund public projects, such as school construction or improvements to utility infrastructures.

Interest on municipal bonds is often exempt from federal tax, making the bonds more attractive to investors in higher tax brackets. And, if a bond is bought by a resident of the state that issued it, interest payments may also be exempt from state and local taxes.

Like other fixed income securities, carefully selected municipal bonds can play an important role in a well-diversified portfolio, helping to minimize overall volatility and providing predictable income and principal protection.

For retirees, municipal bonds may provide a predictable income stream and low risk to capital. For others, they can help to finance future obligations, such as vacations, college funding or the purchase of a home.

However, before investing in municipal bonds, you should understand their structures, features, benefits and risks. In addition to the overview provided below, two good sources of information are the Municipal Securities Rulemaking Board (MSRB) at emma.msrb.org and the Financial Industry Regulatory Authority (FINRA) at finra.org. You may also contact your financial advisor for more information.

GETTING STARTED

Before investing in a municipal bond, you should carefully review the information about it, including its terms, risk factors and the quality of its issuer. One place to find this is the MSRB’s Electronic Municipal Market Access system, or EMMA. The site emma.msrb.org provides free access to a comprehensive, centralized source for the following as well as educational materials about the municipal securities market.

• Official Statements – This document required at issuance discloses the terms of the bond, including how investors will be repaid, issuer’s credit ratings and any known risks. It should also include information on all other pertinent details, such as third-party borrowers that will benefit from the bonds – known as “obligated parties” – such as hospitals or universities.

• Continuing Disclosures – Throughout the life of a bond, the issuer must release information regarding its financial and credit worthiness, material events, as well as other conditions or events that may affect the bond’s value.
EVALUATING THE BOND’S CREDIT QUALITY

Before investing in a particular bond, you should have a thorough understanding of its credit quality, as well as that of its issuer. This will help you determine if the bond is right for your investment needs and level of risk tolerance.

- **Credit Rating** – Rating agencies, such as Standard & Poor’s, Moody's and Fitch, assign credit ratings to a bond based on their perceptions of its quality and the likelihood that the issuer will be able to meet its payment obligations. While a high credit rating by an agency is an indication that it views the bond to be relatively safe, not all bond issues are rated, and even the highest credit rating offers no guarantee of principal or income. Other factors you should consider include whether the bond is insured or if its credit rating has recently changed.

- **Source of Repayment** – Another important factor to consider when assessing a bond’s credit quality is how the issuer plans to repay its debt. The three primary sources of repayment are:
  
  **General Obligation.** Sometimes called a “full faith and credit” bond, a general obligation bond is paid through revenues the issuer receives. Issuers of general obligation municipal bonds have taxation authority and agree to levy taxes in an amount sufficient to make principal and interest payments on outstanding bonds.
  
  **Revenue Bond.** A revenue bond is repaid from the revenues of the project or system the bond is financing rather than from a municipal agency’s general funds.
  
  **Tax-Backed.** A tax-backed municipal bond is repaid from specified tax revenues.

UNDERSTANDING WHY A BOND IS PRICED AS IT IS

If you buy a bond in the secondary market, be sure to ask why the bond is priced as it is. Be aware that the price of a bond can be priced above or below its par value for many reasons, including changes in the credit worthiness of a bond’s issuer and a host of other factors, including prevailing interest rates or yields.

Municipal bonds are typically quoted on a yield to maturity or yield to call basis. Yield is the annual rate of return you can expect to receive on a bond. Multiple factors affect yield, including how the bond’s market price is determined – the higher the price, the lower the yield – often driven by credit quality and time to maturity. In addition, you should consider tax-equivalent yield, which takes into account the effect of paying no federal income tax on the municipal bond.

Generally, higher yields are associated with lower credit quality and, thus, greater risk. Bonds with longer maturities usually pay higher interest rates, and a bond’s value at maturity may be more or less than the price you paid for the bond.

In addition, because interest rates in the municipal bond market are likely to fluctuate during a bond’s lifetime, the issuer may include a “call” option, which allows it to redeem the bond early – of particular interest to the issuer when rates drop. If the issuer exercises this option, investors in the bond generally receive only the principal and interest accrued up to the date the bond is called, plus, in some cases, a small premium. Understanding the terms, if any, under which a bond may be called is important if you plan to rely on it for long-term income.

ENSURING YOU PAY A FAIR PRICE

When you purchase a municipal bond, you have a right to expect to pay fair market price for it. Financial institutions that sell bonds are required to adhere to
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If sold prior to maturity an investor will receive the then current market value which may be more or less than original cost. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise. Investments in municipal securities may not be appropriate for all investors, particularly those who do not stand to benefit from the tax status of the investment. Municipal bond interest is not subject to federal income tax but may be subject to AMT, state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Additionally, the bonds may be subject to capital gains taxes if sold or redeemed at a profit. Diversification does not ensure a profit or protect against a loss. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revision, suspension, reduction or withdrawal at any time by the assigning rating agency. Ratings do not remove market risk. Insurance relates to the timely payment of principal and interest. Insurance does not guarantee market value or protect against fluctuations in bond prices. High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer’s credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of a portfolio.

the fair-pricing rules established by the Municipal Securities Rulemaking Board. Your financial institution should provide you with information about the pricing of its trades. In addition, you can find real-time, recent and historical trade prices for a particular bond through the MSRB’s Electronic Municipal Market Access (EMMA) system at emma.msrb.org.

UNDERSTANDING THE BOND’S TAX IMPLICATIONS AND HOW YOUR FINANCIAL ADVISOR IS COMPENSATED

As with all investment products, you should carefully evaluate how buying municipal bonds may affect your tax situation. Many municipal bonds are tax-exempt, but there are exceptions. Additionally, depending on where you live, the tax treatment of a bond may vary. For example, a bond may be exempt from federal income taxes, but not from state or local taxes. In addition, some municipal bond income may be subject to the alternative minimum tax or AMT. Consult with your tax professional to determine how purchasing municipal bonds may affect you.

Finally, you should understand how your financial advisor is compensated for the investment products – including municipal bonds – he or she sells. Rather than charge a commission on the trade, a financial advisor will generally “mark up” the price of a bond – within the fair-pricing standards established by the MSRB – from the price for which his or her firm originally purchased it. Your advisor should provide you with information on how he or she is compensated from a municipal bond trade.

ACCESSING ADDITIONAL INFORMATION ABOUT MUNICIPAL BONDS

In addition to the information provided here, you should consult with your financial advisor and your tax professional to determine whether investing in municipal bonds is right for you. You can also learn more about municipal bond investing by visiting the following websites:

InvestingInBonds.com
This site from SIFMA (The Securities Industry and Financial Markets Association) is a rich resource for people at every point on the investing spectrum. It offers valuable information, important indicators, as well as market news and commentary. Whether you are just beginning to think about investing in bonds or you are a seasoned investor, this site can answer your questions and provide you with the tools you need to invest in the bond market.

Muni Bond Checklist
http://www.finra.org/Investors/ProtectYourself/InvestorAlerts/Bonds/p118925
Use this checklist, created by FINRA, to help avoid some of the most common pitfalls of municipal bond investing.

Seven Questions to Ask when Investing in Municipal Bonds
http://www.msrb.org/msrb1/EMMA/pdfs/SevenQuestionsstoAskAboutMunicipalBonds.pdf
This fact sheet, created by the Municipal Securities Rulemaking Board, provides potential investors in municipal bonds with a starting point for discussions with their financial professionals about investing in municipal securities.

If sold prior to maturity an investor will receive the then current market value which may be more or less than original cost. There is an inverse relationship between interest rate movements and fixed income prices. Generally, when interest rates rise, fixed income prices fall and when interest rates fall, fixed income prices rise. Investments in municipal securities may not be appropriate for all investors, particularly those who do not stand to benefit from the tax status of the investment. Municipal bond interest is not subject to federal income tax but may be subject to AMT, state or local taxes. In addition, certain municipal bonds (such as Build America Bonds) are issued without a federal tax exemption, which subjects the related interest income to federal income tax. Additionally, the bonds may be subject to capital gains taxes if sold or redeemed at a profit. Diversification does not ensure a profit or protect against a loss. A credit rating of a security is not a recommendation to buy, sell or hold securities and may be subject to review, revision, suspension, reduction or withdrawal at any time by the assigning rating agency. Ratings do not remove market risk. Insurance relates to the timely payment of principal and interest. Insurance does not guarantee market value or protect against fluctuations in bond prices. High-yield bonds are not suitable for all investors. The risk of default may increase due to changes in the issuer’s credit quality. Price changes may occur due to changes in interest rates and the liquidity of the bond. When appropriate, these bonds should only comprise a modest portion of a portfolio.