Municipal Bonds Miss the Mark

ON OUR MINDS

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Old habits die hard, but sometimes they should still die. Fondness for municipal bonds is one of them. The fixed income market has changed enormously in the last few decades, and yet many investors still cling to the notion that they should invest in municipal bonds in order to shield their income from the taxman and realize higher after-tax returns.

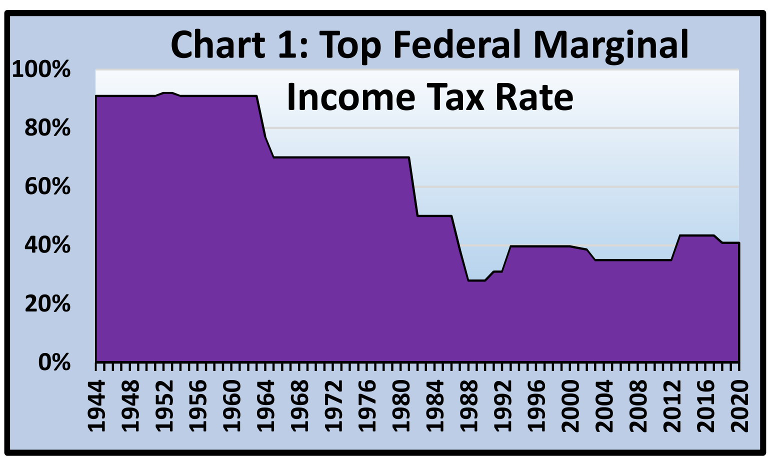
This is the Carly Simon School of Fixed Income Investing. Ms. Simon knew that *that's the way I've always heard it should be,* even as she acknowledged that the world had changed. The characters in her song always did what they were schooled to do, but they regret it all the same: *They hate themselves for what they are / And yet they drink, they laugh / Close the wound, hide the scar.* You see the train wreck coming, but you hop aboard anyway because, well, that's what you were told – and maybe this time will be different.

We don't accept that notion. We don't subscribe to buying muni bonds just because *that's the way we've always heard it should be.* In fact, it's not the way to invest in fixed income today.

The world has changed in two meaningful ways:

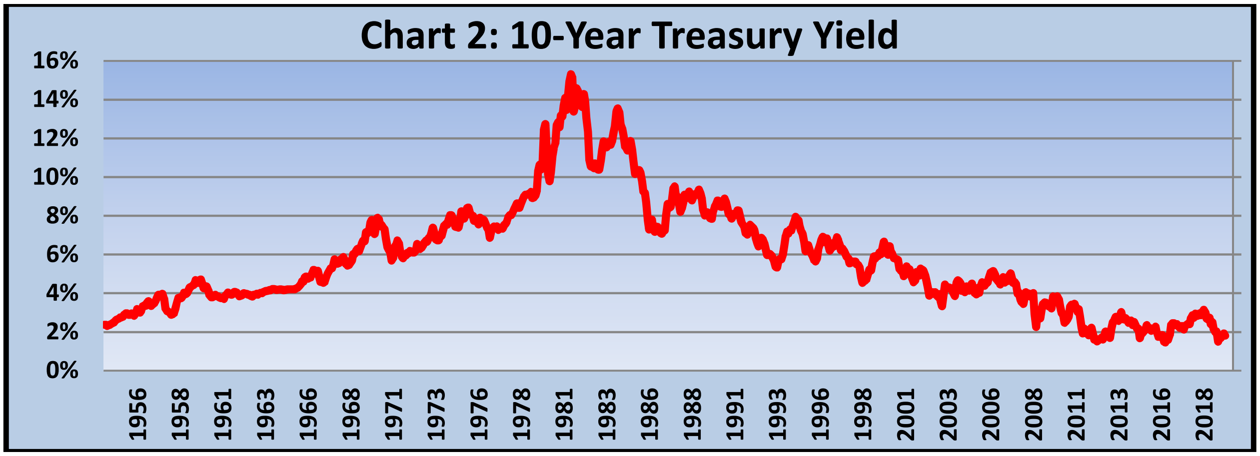
- Tax rates are significantly lower than they were throughout most of the 20th century.
- Bond yields and coupon income have both fallen sharply over the past 30 years.

These two factors have utterly devastated the tax-driven rationale for owning municipal bonds. Throughout the 1970s, the top marginal income tax rate was 70% or more, but that fell to 50% in 1981 and to 28% in 1986 before gradually rising again. Today the top marginal rate is 40.8%, so the tax bite on a dollar of bond coupon interest is still lower than it was a generation ago. (See Chart 1.)



Source: Internal Revenue Service

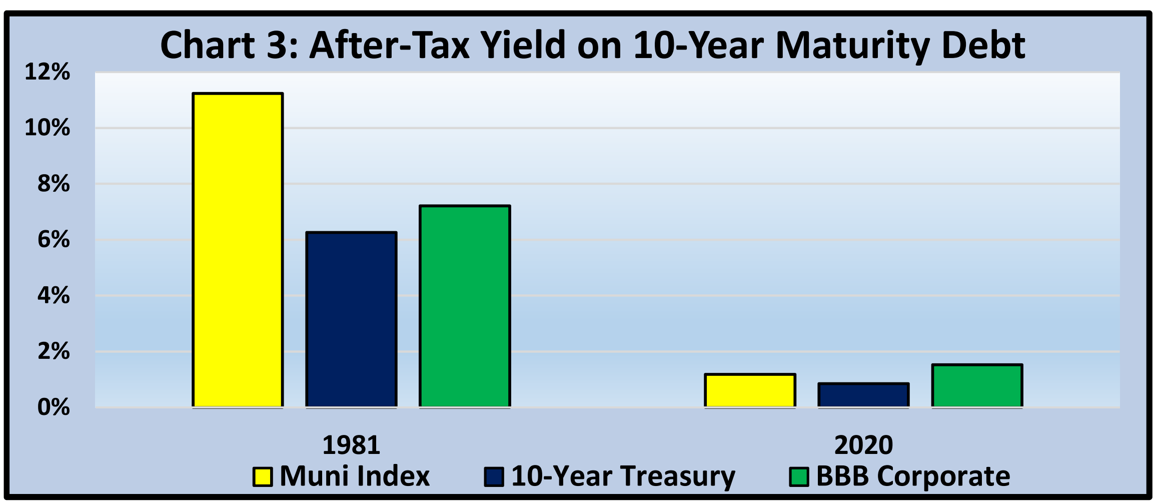
Similarly, in 1981, a 10-year Treasury note yielded (pretax) about 14% (see Chart 2), and municipal debt traded at comparable yields; so buying a $1,000 municipal bond provided about $140 of income. Today, that same bond would give its owner about $15.80 of pretax income – an 88% drop from 1981 levels.



Source: FactSet

Putting these two changes – yields and taxes – together suggests that the purported tax benefits of owning municipal debt are almost entirely illusory. After taxes, that 1981 municipal bond preserved about $76 of income per $1,000 invested, so it made good sense at that time to take the incrementally higher credit risk; today, at the top 40.8% marginal federal income tax rate, that muni would save only about $6.45 per $1,000 invested, while the credit risk remains slightly elevated. Yesterday's wisdom is today's rounding error.

Chart 3 shows the combined effects of lower yields and lower taxes on municipal debt in comparison to corporate or Treasury debt. In 1981, the advantage of muni bonds was manifest; today it is almost invisible.



Source: https://www.govinfo.gov/content/pkg/ERP-2012/pdf/ERP-2012-table73.pdf, Bloomberg

These are not passing fads, but structural changes to the nature of fixed income investing. Our nation's population growth has slowed and our dependence on foreign energy sources has virtually disappeared; both factors imply that lower inflation and lower interest rates will be permanent features of the American economy and securities markets. The appetite for sharply raising marginal income tax rates is similarly absent from the halls of Congress, even if some presidential candidates harbor dreams of soaking upper-income taxpayers.

The upshot is simply that investors are earning less of their current income from bond coupons, and they are paying lower taxes on that lower income. The savings from owning municipal debt are vanishing. These are long-term changes that – regardless of how you've heard it should be – make municipal bonds less attractive to high-income investors. (They have almost never been attractive to investors in lower tax brackets.)

The current market environment makes municipal debt even less appealing, in comparison with other fixed income asset classes. While municipals traded at nearly the same yields as Treasury debt in 1981 (and at many times since then), today the nominal yields on municipal bonds are about 25% to 40% below those of comparable-maturity Treasury debt, as shown in Chart 4:

Chart 4: Current Bond Market Yields

	1-year	2-Year	3-year	5-year	10-year	30-year
U.S. Treasury	1.47%	1.41%	1.39%	1.41%	1.58%	2.05%
BBB-Rated Corp Index	1.89%	1.92%	1.98%	2.21%	2.83%	3.56%
Municipal Index	0.84%	0.84%	0.84%	0.86%	1.19%	1.82%
Muni Tax Equivalent	**1.33%**	**1.33%**	**1.33%**	**1.36%**	**1.90%**	**2.88%**

Source: Bloomberg

You can buy a 5-year municipal bond today and earn 0.86% on it. If you're in the highest tax bracket, the tax-equivalent yield is 1.36%. By comparison, you can also buy a zero-risk Treasury note with the same maturity and earn a better yield: Lower price and higher quality make the Treasury debt clearly the better asset. Dipping a bit further in quality to BBB-rated corporate debt will give you nearly a full percentage point more tax-equivalent yield than the muni debt. The same story is true for all shorter maturities: For anything under five years, municipal debt is a suboptimal way to generate income. The story is slightly different for longer maturities, where municipal debt does carry slightly higher tax-equivalent yields than Treasury debt; the longer maturities carry somewhat higher default risk, however. Even in the longest maturities, corporate debt offers better tax-equivalent yields for comparable credit risk.

Every investor is unique, of course, and there may be instances in which any given investor's circumstances require the use of municipal bonds rather than Treasury or corporate debt. But those isolated instances don't change the general point that municipal debt, as an asset class, is less useful today even for investors in the highest tax brackets. You may have always heard that it should be in your portfolio, but yesterday's verities just don't work in today's markets.