Municipal Bonds 101

Municipal bonds are issued by government entities such as cities and states or their agencies. Essentially by investing in a bond, the investor lends money to the municipality or the municipal agency. These bonds support such projects as the building of roads and schools, water and sewer projects, or even jail, airport, and hospital construction. These bonds are typically issued in increments of $5,000.

The unique element of municipal bonds is the interest earned is exempt from federal income tax and may not be subject to state income tax. In comparing taxable government or corporate bonds to municipal bond interest, one should consider the tax-equivalent yield of the bonds. A tax-equivalent yield is the after-tax yield an investor would receive on a taxable bond compared to the already tax-free yield of a municipal bond. The tax-equivalent yield is dependent on the investor’s individual income tax bracket and can be easily calculated by a financial advisor. The higher one’s tax bracket, the more attractive municipal bonds become since the income is federally tax exempt.

Municipal bonds can be either General Obligation (G.O.) or Revenue bonds. The key difference between the two types is how the interest and principal payments are supported. G.O. bonds are backed by the taxing authority of the issuing municipality or agency. School districts and local governments often issue G.O. bonds. Revenue bonds are backed by the source of revenue created by the underlying project the bond is financing. Common examples of revenue bonds are airport, hospital, or stadium bonds. The interest and principal payments are paid through the revenues these projects create.

Just as individuals have credit scores, municipalities or their agencies carry credit ratings to indicate their creditworthiness. There are three main rating agencies: S&P, Moody’s and Fitch. Not all bond issuers are scored by all three ratings agencies and some, especially smaller issuers, are not rated. Bond ratings range from AAA (highest) to D (default). A high bond rating doesn’t necessarily mean a bond will not default, but there is a lower chance of default in a highly rated bond versus a lower rated bond. G.O. bonds often have higher credit ratings than do revenue bonds because of the inherent nature of the taxing power of the issuing jurisdiction.

Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Because interest income may be subject to the alternative minimum tax, one’s tax advisor should be consulted before investing in municipal bonds. Municipal bonds offer the unique advantage of federally tax-free income while at the same time they help capitalize schools, roads, hospitals, and other projects that benefit “the greater good”.

*Adam Smit is the President of Adam Smit Investment Management LLC. He is a registered principal of LPL Financial. Adam has eight years of experience as a registered financial advisor. Adam believes that developing a plan is the first step in helping his client’s pursue their financial goals. His practice emphasizes an investment philosophy of investing in quality while holding for the long-term. He may be reached at 715-644-3434. Securities offered through LPL Financial. Member FINRA/SIPC.*