MassMutual

An Introduction to Municipal Bonds

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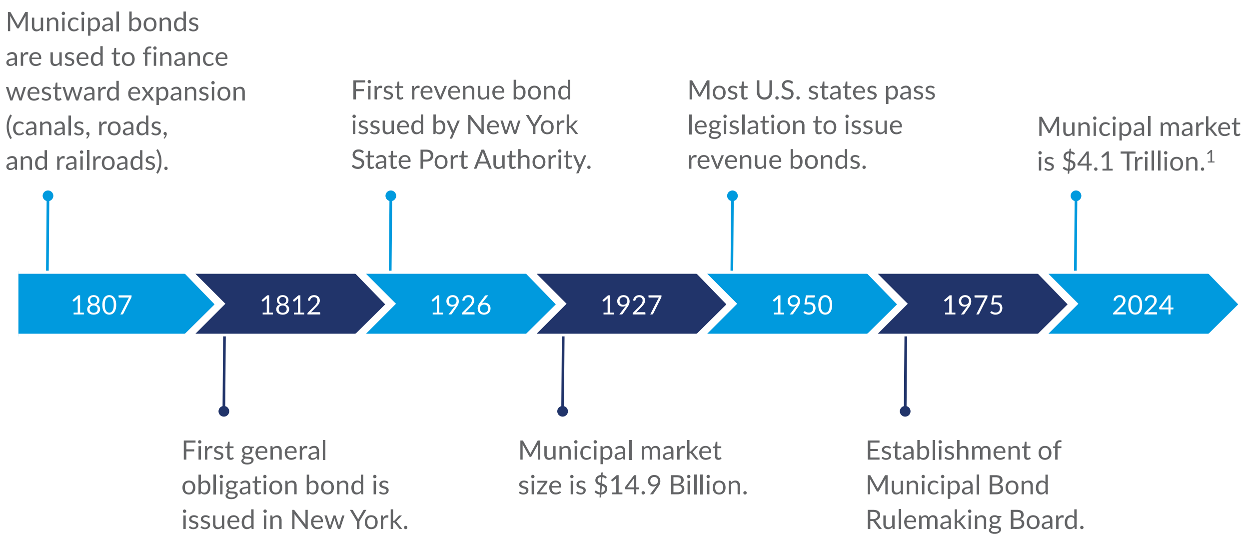
Summary

- Municipal bonds (munis) have been utilized in the United States for nearly two centuries to fund innovation and expansion.
- The most common types of muni bond securities are general obligation (GO) and revenue bonds, with the interest on these bonds potentially exempt from federal, and in some instances, state and local income taxes.
- Munis historically have experienced low relative default rates since they are backed by government entities.

In the first paper of our muni bond education series, we provide an introduction to municipal bonds, including their various types of debt securities, tax benefits, opportunities as well as risks.

THE MUNICIPAL BOND TIMELINE



Background and objective

Munis are essential for building and maintaining the U.S. infrastructure, as the bonds have been utilized for almost 200 years in the United States (as shown above) to fund innovation and expansion. Municipal entities of all types including states, cities, counties, and towns use munis to fund day-to-day operations and capital projects such as schools, highways and sewer systems.

By purchasing munis, investors are effectively lending money to the municipality in exchange for regular interest payments, usually semi-annually (twice per year), and repayment of their original investment, or principal. A muni's maturity date — the date when the bond's obligor pays back the principal — could potentially be years in the future. Most municipalities use conduit issuers that are not ultimately repaying the debt service. Taxes, fees, and revenues that secure bonds are collected by the conduit issuer from the borrower and then paid to the bondholders, but the conduit issuer is usually not responsible for repayment. Rather, it's the borrowing organization that must repay interest and principal on the bonds, unless stipulated otherwise in a written agreement. Short-term bonds generally mature in one-to-three years, while long-term bonds usually don't mature for more than 10 years.

[1] Source: Securities Industry and Financial Markets Association (SIFMA), U.S. Municipal Bond Statistics as of December 31, 2024.

Types of muni bonds

The two most common types of municipal bonds are:

1. GO bonds that are issued by states, cities, or counties and are not secured by assets. GO bonds are typically backed by the obligor's full faith and credit, predominantly their power to levy taxes on residents to repay bondholders.
2. Revenue bonds are not backed by government's taxing power but by revenues from a specific project or source, such as highway tolls or lease fees. In essence, these are intended to be "self-supporting" bonds (fees and/or project-specific revenues are projected to support debt service). Some revenue bonds are "non-recourse," meaning that if the revenue stream dries up, the bondholders do not have a claim on the underlying revenue source.

	GO Bond	Revenue Bond
Obligor:	• States • Cities • School districts	• Transit agencies • Water districts and public power providers • Hospitals • Higher education institutions
Repaid with:	The general revenues of the entity, including: • Income taxes on residents, if applicable • Property taxes	Funds from a specific source: • Road tolls • Utility fees • Hospital revenues • University tuition and fees • Water and sewer charges

April 2021, Investor.gov Securities Exchange Commission, Municipal Bonds.

Tax efficiency

Munis are generally referred to as tax-exempt bonds because the interest earned on the bonds is often excluded from gross income for federal income tax purposes and, in some cases, is also exempt from state and local income taxes. However, the investor must generally reside in the state where the bond was issued for muni interest to be free from state and local taxes. Given their tax benefits, the interest rate for municipal bonds is usually lower than on comparable taxable fixed-income securities such as corporate bonds and U.S. Treasury bonds.

But it's important to keep in mind that not all municipal bonds are tax exempt. Municipal obligors can issue taxable bonds if the purpose of the obligors' financing does not meet a certain purpose or public use case under federal tax rules. And certain municipal bonds, such as private activity bonds, are subject to the federal alternative minimum tax (AMT), which is an alternative way of computing taxes that is mandated by the Internal Revenue Service (IRS) for income over certain thresholds.

Safe but with risks

Because they're backed by government entities and/or essential services, muni bonds generally come with a low risk of default. Generally speaking, municipal bond payments are typically backed by taxes or user fees from services that are often essential. They are generally considered "safe" investments because default rates have been historically lower than those for comparable corporate bonds. This is due, in part, to state governments not being allowed to declare bankruptcy under Chapter 9 of the U.S. bankruptcy code.[2]

However, GO bonds, when issued by municipalities such as cities and counties, can default as the issuing entities are not constrained under Chapter 9. Similarly, if an enterprise does not generate enough revenue to cover operational expenses, then a revenue bond, whether issued by a state or municipal enterprise, may default. Additionally, some municipal bonds, such as high yield municipal bonds, may be risky. Investors need to review the specifics of any particular muni bonds to evaluate and assess the associated risks.

The following are general risks associated with investing in municipal bonds:

- **Credit/Default —** The risk of credit downgrade or change in credit spread; and the risk that a bond obligor won't be able to make scheduled interest or principal payments.
- **Liquidity/Reinvestment —** The greater the liquidity risk, the harder it is to sell a security, or the greater the loss in value resulting from a sale; the risk that an investor will not be able to reinvest the proceeds received at the same or higher rate at a bond's maturity.
- **Interest/Call —** While a fixed rate bond will pay the same rate of interest throughout the bond's life, changes in interest rates can impact a bond's market value. Interest rates and bond prices have an inverse relationship, so if market interest rates rise, the price of a bond will fall (the reverse is also true). Call risk is the risk that a bond may be redeemed by the obligor prior to maturity, which means that an investor will lose the ability to collect interest from the time the bond is redeemed to the scheduled maturity date (reducing the bond's overall return).

2 Federal Reserve Bank of Chicago, Chicago Fed Letter, No. 451, February 2021.

The potential opportunity

In summary, muni bonds can be a popular investment option because they may potentially offer:

Low default rates	Muni bonds generally have low relative default rates because they are backed by a government entities' taxes and user fees.
Tax advantages	Interest income from most municipal bonds is often exempt from federal income tax, and interest may also be exempt from state income taxes if you buy bonds from an entity in your home state.
Steady/Predictable income	Muni bonds are popular with investors as a way of earning a steady paycheck from their portfolio. Most municipal bonds pay interest twice a year, so barring default you know exactly how much to expect and when you'll receive it.
Local investment	Munis offer an opportunity to invest your money locally. You may be knowledgeable about the issuing municipality, or the projects being funded, which may help you make more informed bond-buying decisions.

This material is educational in nature and does not constitute a recommendation to engage in or refrain from a particular course of action. The information within has not been tailored for any individual.

Investors should consider funds' objectives, risks, fees, and expenses carefully before investing. This and other information can be found in the funds' prospectuses or summary prospectuses, which are available from MassMutual by calling 1-866-444-2601. Please read them carefully before investing.

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