Municipal Bonds 101

The Potential Opportunity

- Steady/Predictable Income
- Safe but with risk
- Tax efficiency
- Local investment

Background

Municipal bonds **(munis)** have been utilized in the United States for nearly two centuries to **fund innovation and expansion**.

- **1807** — Municipal bonds are used to finance westward expansion (canals, roads, and railroads).
- **1812** — First general obligation bond is issued in New York.
- **1926** — First revenue bond issued by New York State Port Authority.
- **1927** — Municipal market size is $14.9 Billion.
- **1950** — Most U.S. states pass legislation to issue revenue bonds.
- **1975** — Establishment of Municipal Bond Rulemaking Board.
- **2024** — Municipal market is $4.1 Trillion.[1]

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

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.

Short-term bonds generally mature in one-to-three years, while **long-term bonds** usually don't mature for more than 10 years.

Types of Munis

The most common types of munis are:

1. **General Obligation (GO)** bonds are issued by states, cities or counties and are typically backed by 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.

Steady/Predictable Income

Muni bonds are popular with investors as a way of **earning a source of income** 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.

Tax efficiency

- Generally referred to as **tax-exempt bonds**.
- Interest often **excluded from gross income** for federal income tax purposes.
- Also generally **exempt from state and local income taxes** if the investor resides in the state where the bond was issued.
- But some municipal bonds are **not tax exempt**.

Safe but with risks

Munis 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.)[1]

However, GO bonds, when issued by municipalities such as cities and counties, **can 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 following associated risks:

- **Credit/Default**
- **Liquidity/Reinvestment**
- **Interest/Call**

Local investment

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.

[1] Federal Reserve Bank of Chicago, Chicago Fed Letter, No. 451, February 2021.

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