

Practice Essentials[®]

Taxable Municipal Bonds

Increased yield and diversification benefits for this asset class explained.

Municipalities have been issuing taxable municipal bonds since 1986. In that year, the federal government enacted strict Treasury guidelines on the qualifications for tax-exempt financing. Today, in accordance with those guidelines, the government will not subsidize the financing of activities which do not provide what the government considers to be a significant benefit to the general public. Investor-led housing, local sports facilities, and borrowing to replenish a municipality's underfunded pension plan are just three examples of bond issues that do not qualify for tax-exempt status.

The establishment of the Build America Bond (BAB) program contributed to a surge in taxable municipal bond issuances, dramatically increasing the supply of taxable municipal bonds outstanding for the investing public. In this paper, we will outline the taxable municipal bond market and the new issuance programs created to assist local governments in funding their programs.

The Municipal Bond Market

Municipal bonds are issued by a wide variety of entities for many different purposes. As of September 30, 2011, there are over 1.5 million municipal bond issues aggregating approximately US\$ 3.73 trillion outstanding. In comparison, the debt outstanding for federal agencies is approximately US\$ 2.4 trillion, while debt belonging to the category of money markets is just shy of US\$ 2.7 trillion.¹

Municipal bond issues are held by individual investors, mutual funds, banks, insurance companies, and other financial institutions. While municipal bonds have historically had low default rates, the credit quality of the issuer (borrower) can vary, and some sectors and sub-sectors are more prone to default than others.

While the security or credit backing of a municipality's taxable bonds is typically no different from that of its tax-exempt bond equivalent, taxable municipals offer yields more comparable to those of other taxable fixed income sectors such as corporate bonds or bonds issued by U.S. government agencies. However, municipal bonds seem to entail less risk than similar corporate bonds, when historical default rates are considered (please see analysis in previous *Practice Essentials* paper, *Fixed Income 101: Municipal Bond Basics*).²

The American Recovery and Reinvestment Act of 2009

On February 17, 2009, President Obama signed economic stimulus legislation officially entitled the American Recovery and Reinvestment Act of 2009 (ARRA). ARRA encourages more activity in the public finance sector by, among other initiatives, introducing new types of municipal bonds. One particular initiative, known as the Build America Bond program, allowed state and local governments to issue an unlimited amount of taxable debt through the end of 2010. Legislators in Washington are currently discussing the possibility of reinstating this program. In 2009, over US\$ 64 billion worth

Recent legislation and the establishment of the Build America Bond program have contributed to a surge in taxable municipal bond issuances.

¹ SIFMA, September 30, 2011.

² S&P Indices Practice Essentials - Fixed Income 101: Municipal Bond Basics

(http://spindices.com/assets/files/portal/PracticeEssentials_MunicipalBondBasics.pdf), June 2010

of BABs were issued. In 2010, another US\$ 117 billion in BABs were issued, equating to just over 27% of the total US\$ 433 billion municipal bond issuance that year.³

Build America Bonds

Like their tax-exempt counterparts, Build America Bonds are vehicles that allow the federal government to subsidize state and local government obligations. However, BABs are different from tax-exempt bonds in that the interest paid to bondholders is taxable, and a portion of the interest consists of a federal tax credit. These bonds have an innovative feature, the Direct Payment Option, which allows the issuer to receive a direct payment from the U.S. Treasury to apply toward debt service of the bonds issued.

Given certain market conditions, the Direct Payment Option offers municipalities a better interest subsidy, particularly in longer maturity bonds. The issuer will receive, as of each interest payment date, a payment equal to 35% of the interest payable to bondholders. For example, on bonds with a 7% coupon, the issuer will pay an effective interest rate of 4.55% with the remainder of the coupon payment, in this scenario 2.45%, funded by the federal government. This 35% federal subsidy is guaranteed to the issuer for the life of the bond. In contrast, the “subsidy” for those who invest in tax-exempt bonds is dependent on the income tax bracket of the investor and may vary over time with changes in the tax code or income levels.⁴

Build America Bonds are intended to expand the potential market of municipal bonds by attracting buyers who typically prefer taxable bonds to tax-exempt bonds. Potential investors of BABs include retail investors in lower income tax brackets, individual retirement accounts, public pension funds, and foreign investors. For these tax advantaged investors, the higher yield of these bonds (see table below) versus tax-exempt municipal issues can be very attractive. In fact, the yields of the S&P Municipal BAB and S&P Municipal BAB Select Indices are somewhat higher than the taxable equivalent yield of a similar tax-exempt index, the S&P National AMT-Free Municipal Bond Index, as shown in the table below.

Nevertheless, it is important to mention that historical yields may not be indicative of future bond performance.

BABs are different from tax-exempt bonds in that the interest paid to bondholders is taxable, and a portion of the interest consists of a federal tax credit.

³SIFMA, July 5, 2011.

⁴Nothing in this document should be construed as tax advice. S&P does not offer tax advice. Any tax related questions should be discussed with a tax professional.

Exhibit 1: Municipal Bond Indices

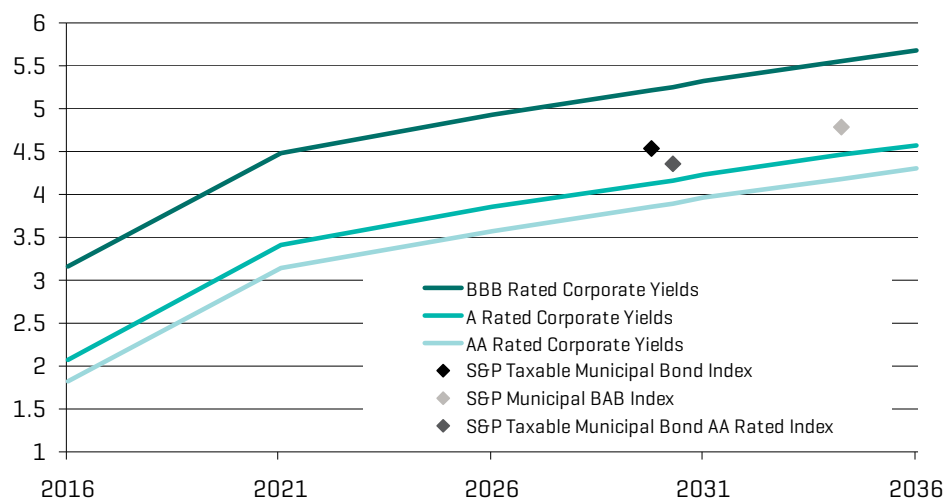
Index	Weighted Avg Coupon	WA Maturity	WA Yield	Taxable Equivalent Yield	BloombergSM Ticker
S&P National AMT-Free Municipal Bond Index	4.57%	5/3/2026	3.32%	5.11%	SPMUNUST
S&P Taxable Municipal Bond Index	5.42%	9/27/2030	4.51%	4.51%	SPMUTT
S&P L/T Intermediate Taxable Municipal Index	4.66%	12/17/2021	3.96%	3.96%	SPMUTLT
S&P Municipal BAB Index	6.01%	4/3/2035	4.75%	4.75%	SPMUTBT
S&P Municipal BAB Select Index	6.30%	3/24/2039	4.98%	4.98%	SPMUTBST

Taxable Equivalent Yield calculated for S&P National AMT-Free Municipal Bond Index using 35% tax rate. Source: Standard & Poor's. Data as of Dec. 30, 2011. Charts and graphs are provided for illustrative purposes only. Indices are unmanaged, statistical composites. Yields do not reflect the effect of any sales charges or fees an investor would pay to purchase the securities the Indexes represent. Such charges or fees would change the yields and reduce total return over time. It is not possible to invest directly in an index. Yields can and do change over time and past yields are not an indication of what future yields will be. Past Performance is not an indication of future results.

The corporate credit yield curve data for Dec. 28, 2011, shown below, provides additional fodder for comparison. Standard & Poor's Global Fixed Income Research department produces yield curve data on the corporate bonds in its coverage universe. Over 61% of S&P Taxable Municipal Bond Index constituents were rated AA or higher by Standard & Poor's. For the S&P Municipal BAB Index, the number is over 65%. Given that the yields for these municipal bond indices fall between that of BBB and A rated corporate credits, it appears that investing in municipal bonds can provide an attractive risk-reward option when compared to corporate bonds of similar maturity and ratings quality.

Given certain market conditions, the Direct Payment Option offers municipalities a better interest subsidy, particularly in longer maturity bonds.

Exhibit 2: S&P GFIR Corporate Yield Curve Data – 12/28/11



Source: Standard & Poor's. Data as of Dec. 28, 2011. Charts and graphs are provided for illustrative purposes only. Indices are unmanaged, statistical composites. Yields do not reflect the effect of any sales charges or fees an investor would pay to purchase the securities the Indexes represent. Such charges or fees would change the yields and reduce total return over time. It is not possible to invest directly in an index. Yields can and do change over time and past yields are not an indication of what future yields will be. Past Performance is not an indication of future results.

S&P Taxable Municipal Bond Indices: Measuring the Market

S&P Indices publishes a detailed set of data about the municipal bond market in the form of various municipal bond index families. The indices provide data that can be used as a tool to learn more about how the municipal market is performing. In addition to providing data showing how the market is moving, the indices provide increased transparency into key characteristics of the market such as weighted average bid prices, yields, and quality.

Additional Resources

The Rieger Report Podcast: www.spindices.com/commentary

S&P Indices Practice Essentials: www.spindices.com/education

S&P Indices Market Attributes®: www.spindices.com/commentary

S&P Indices Thought Leadership Center: www.spindices.com/

S&P Fixed Income Indices: www.fixedincomeindices.standardandpoors.com

S&P Taxable Municipal Bond Index & Sub-Indices

BLOOMBERG SM Tickers	Description
SPMUTT	<i>S&P Taxable Municipal Bond Index</i> A broad, comprehensive, market value-weighted index designed to measure the performance of the investment-grade U.S. taxable municipal bond market.
SPMUTSLT	<i>S&P Taxable Municipal Bond Select Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index with a Minimum Par Amount greater or equal to US\$ 10 million and, on the Rebalancing Date, 75% of the market value of the index are from bonds that are part of a deal where the original offering amount was at least US\$ 100 million.
SPMUTS	<i>S&P Short Term Taxable Municipal Bond Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index with a maximum maturity of up to but not including one year as measured from the first Business Day of the month.
SPMUTSI	<i>S&P Short Intermediate Term Taxable Municipal Bond Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index with a minimum maturity of one year and a maximum maturity of up to but not including five years as measured from the first Business Day of the month.
SPMUTLT	<i>S&P Long Intermediate Term Taxable Municipal Bond Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index with a minimum maturity of five years and a maximum maturity of up to but not including 15 years as measured from the first Business Day of the month.
SPMUT15T	<i>S&P 15 Year+ Taxable Municipal Bond Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index with a minimum maturity of 15 years or longer as measured from the first Business Day of the month.
SPMUTBT	<i>S&P Municipal BAB Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index that are designated as Build America Bonds issued under "The American Recovery and Reinvestment Act of 2009", with a Minimum Par Amount greater or equal to US\$ 1 million.
SPMUTBST	<i>S&P Municipal BAB Select Index</i> Consists of bonds in the S&P Taxable Municipal Bond Index that are designated as Build America Bonds issued under "The American Recovery and Reinvestment Act of 2009", with a Minimum Par Amount greater or equal to US\$ 100 million.
SPMUT3AT	<i>S&P Taxable Municipal AAA Rated Bond Index¹</i> Consists of bonds in the S&P Taxable Municipal Bond Index with an S&P rating of AAA.
SPMUT2AT	<i>S&P Taxable Municipal AA Rated Bond Index¹</i> Consists of bonds in the S&P Taxable Municipal Bond Index with an S&P rating of AA-, AA, or AA+.
SPMUT1AT	<i>S&P Taxable Municipal A Rated Bond Index¹</i> Consists of bonds in the S&P Taxable Municipal Bond Index with an S&P rating of A-, A, or A+.

¹S&P Ratings did not participate in the development of The S&P Taxable Municipal AAA Rated Bond Index, The S&P Taxable Municipal AA Rated Bond Index, or The S&P Taxable Municipal A Rated Bond Index (collectively, "Indices") nor does S&P Ratings participate in the maintenance of the Indices. A municipal bond's credit rating is not the sole criterion for determining membership in the Indices. Credit ratings are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions. Credit ratings should not be relied on and is not a substitute for the skill, judgment and experience of financial advisors and/or investors when making investment decisions. Credit ratings do not address the suitability of any security.

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