

An aerial night photograph of a city street grid, illuminated by streetlights and building lights. A large blue rectangular box with a dotted white border is centered in the upper half of the image, containing the title text.

# INVESTING IN MUNICIPAL BONDS

LIKE ANY OTHER INVESTMENT,  
YOU SHOULD KNOW AS MUCH AS  
POSSIBLE ABOUT THE MUNICIPAL  
BONDS YOU'RE INVESTING IN  
TO MAKE AN INTELLIGENT AND  
INFORMED DECISION.



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## WHAT IS A MUNICIPAL BOND?

In the United States, state and local governments, as well as other public entities, issue municipal bonds and notes to fund infrastructure developments such as schools, medical facilities, and public roads. Municipal bonds—also known as municipal securities—are a cost-effective method to finance projects over their useful lives while minimizing the impact on property tax and/or user rates.

According to some historical records, the modern U.S. municipal bond came about in the early 1800s, when New York City granted a petition to issue \$900,000 of funding bonds to finance its City Hall, an almshouse, and other improvement projects.<sup>1,2</sup> Since then, public entities have issued municipal bonds to finance vital public works projects, refinance existing debt, and manage the growth of their communities.

## HOW BIG IS THE MUNICIPAL MARKET?

According to Moody's, the municipal bond market consisted of \$3.8 trillion issued by approximately 50,000 tax-exempt issuing authorities across the country. Both institutional and individual investors execute approximately 40,000 municipal bond trades for a par value of approximately \$11.6 billion every day.<sup>3</sup>

The size and breadth of the market makes sense given that two thirds of all municipal securities issued finance infrastructure projects across the United States, and the remaining third are generally issued to refinance a previous bond issuance or unwind existing municipal debt.

In the past decade, state and local governments and other authorities issued an average of \$435 billion in new municipal securities every year.<sup>3</sup>

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1 "The first officially labeled 'municipal bond' was issued by New York City in 1812 for the purpose of the construction of the City Hall." Cockren, W., Vecchiotti, M, and Zerbo, D. (1980). Local Finance: A Brief Constitutional Theory. Pg. 135. Fordham Urban Law Journal.

2 "The petition ... was granted in 1812 and the history of funded debt in New York City was begun." Duran, E. (1898). The Finances of New York City. Pg. 33-35. The Macmillan Company.

3 Muni Facts (2019). Municipal Securities Rulemaking Board.

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## WHY DO PEOPLE INVEST IN MUNICIPAL BONDS?

Municipal bonds can be a good investment for various reasons. While earning tax-exempt interest income might be their main selling point, there are many reasons you should consider adding them to your investment portfolio, including:

- **Wealth preservation and income generation**

Municipal bonds might be a good option for you if you're looking to preserve your wealth. When investing in municipal bonds, you receive regular interest payments until the bond reaches its maturity date, at which time your originally invested cash (often referred to as "principal") is returned in full.

- **High credit quality and decreased default risk relative to other asset classes**

According to Moody's most recent report on municipal bond defaults and recoveries in the U.S., municipal bonds have historically observed high credit ratings and low default rates. Credit ratings take into account the risk of default and indicate risk of potential loss to investors. According to the Municipal Securities Rulemaking Board (MSRB), the municipal securities default rate is 0.18 percent compared to 1.74 percent for corporate securities.

- **Greater after-tax returns than many taxable bonds**

Municipal bonds often boast a higher after-tax yield than taxable bonds. Even if a taxable bond offers a higher interest rate, municipal bonds sometimes prove more attractive because interest income is exempt from federal income taxes and sometimes state and local taxes if you reside in the same state in which the bond is issued (however, some bonds may be subject to alternative minimum tax).

- **Consistent and predictable income**

Purchasing municipal bonds enables you to prearrange a consistent source of income. Like any other borrower, state and local governments and other issuing authorities must make regular interest payments to their bondholders. In exchange for your loaned capital,

you receive scheduled interest payments (usually every six months) over a predetermined time period.

- **Community-focused investments**

Because municipal bonds finance projects that add value to communities, your investment helps grow your own wealth while also contributing to community improvement. And you're not alone. According to the MSRB, municipal bonds fund two-thirds of U.S. infrastructure projects and individual investors hold two-thirds of the nation's municipal securities —either through direct investments or indirectly through mutual fund investments.



## 4 THINGS YOU SHOULD KNOW WHEN INVESTING IN MUNICIPAL BONDS

In order to make an informed investment decision, you should know as much as possible about the municipal bond you're going to invest in. However, like most people who dip their toes in unfamiliar waters, it's hard to get the right answers when you don't know which questions to ask. Below are some important things you should know about the municipal bond you're thinking about buying:

### 1. **Official statements and continuing disclosures**

Prior to issuing a bond, state or local governments must publish an official statement. In this document, you can find the bond terms, credit rating, and relevant financials of the issuer. If the proceeds from the bond issuance will be loaned to a third party for funding purposes—such as a university or other quasi-public agency—the borrower's (or obligated party's) financial disclosures will be included in the official statement as well.

Issuers and obligated parties are also required to disclose financial statements, changes in financial condition, and/or changes in credit ratings throughout the life of the bond issuance. These changes may affect the value of the bond, so it's important to stay on top of these disclosures.

### 2. **Credit quality**

Before investing in a municipal bond, you should make sure it aligns with your risk profile, tax status, and overall investment goals. When considering credit quality, the first thing you should understand is how the bond is repaid, or the source of repayment. When it comes to repayment, bonds are split into two classifications: general obligation bonds, which are paid with state and local government revenues and taxing power, and revenue bonds, which are paid with revenue garnered by the project or system being financed, such as a university or a toll road.

Another thing you must consider is whether the municipal bond is senior debt, which the issuer pays first, or subordinate debt, which is secondary in priority. Since state and local governments have more than one issuance at a time, you should also find out whether they have other obligations that they will pay first.

Lastly, and possibly most importantly, you should know the bond's credit rating. Rating agencies such as Moody's Investors Service, S&P Global Ratings, and Fitch Ratings, among others, rate municipal securities to help inform investors about the issuer's possibility of defaulting on their issuance. Rating agencies determine a bond's credit rating based on a variety of factors, including the likelihood an issuer will make interest payments, credit enhancements, and bond insurance. As credit ratings may change, it's important to keep an eye on the rating of the municipal securities in your portfolio.

### 3. **Bond yield**

Bond yield is the return, or interest, you earn every year. You can calculate yield by dividing the coupon rate (the amount of interest payable on a bond calculated as a percentage of the bond's principal amount) by the bond's par value (the price you pay for the overall bond and the amount returned to you when the bond matures).<sup>4</sup>

At a high level, you can generally expect to earn a higher yield on bonds with lower credit quality as a result of the increased risk of your investment. Moreover, bonds with longer maturities also have higher yields due to the risk involved as a result of their longer life span.

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<sup>4</sup> Bond Prices and Yields. (n.d.). Municipal Securities Rulemaking Board Education Center.

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A variety of factors can influence bond yield, including interest rate fluctuations and maturity dates. In regards to prevailing market interest rates, when interest rates rise or fall they affect the price of previously issued bonds causing them to be priced in the secondary market as one of the following:

- **Premium bonds.** Bonds with a coupon rate that is higher than current interest rates are priced at a premium. While these bonds are priced higher than their face value, premium bonds are appealing to investors because they provide higher interest payments over the life of the bond.
- **Discount bonds.** Bonds with a coupon rate lower than current interest rates are priced at a discount. Discount bonds are priced lower to make them more appealing to investors who have the option of buying similar bonds with a better return.

Another factor that can affect bond yield is the maturity date of an issuance. Most bonds are issued in the primary market with a specified maturity date. This date is static and does not change, even if the bonds are sold in the secondary market—with the exception of callable bonds.

“Yield to maturity” is a formula that expresses the estimated internal rate of return of a bond investment if it is held until maturity, all interest and coupon payments are made on schedule, and each payment is reinvested at the same rate. However, some factors can influence the overall yield of a bond. These factors can be calculated using two estimated return formulas:

- **Yield to call.** Certain bonds include a “call” option for the issuer which allows them to redeem (or pay off) a bond prior to its maturity date. Often, an issuer will choose to do this if interest rates fall and they can issue new bonds at a more favorable rate. The “yield to call” figure tells investors the amount of return they can expect if a bond is held until its call date.

*Note:* When a bond is called away, you will only receive interest and principal payments up until the point the issuer redeems the bond. This is an important characteristic to look for before investing in a municipal bond, especially if you plan to depend on bi-annual interest payments as a consistent and predictable source of income.

- **Yield to worst.** Because bonds have various provisions that can affect the overall return on a bond investment (prepayments, calls, and/or sinking funds), “yield to worst” is a formula that helps investors evaluate a bond based on the lowest possible yield (outside of outright issuer default). Using this formula helps investors better manage risk and income requirements in a worst-case scenario.

#### 4. Tax considerations

While most investors add municipal bonds to their overall asset allocation strategy because of their tax-exempt status, there are also taxable bonds, as well as scenarios in which the tax-exempt status of a bond is nullified based on where the bond is issued and where you reside.

Generally, municipal bonds provide investors with interest payments that are exempt from federal income taxes. In most cases, if you live in the same state where the bond is issued, interest payments will also be exempt from state and local taxes. However, some states will also exempt investors who live in other states from paying taxes on the interest income.

Other factors can affect a bond’s tax exemption, including investing in bonds under tax-advantaged plans like IRAs and 401(k)s, and investing in discount bonds in the secondary market.

Investing in municipal bonds should be part of an overall financial plan that takes into account your tax bracket and the various tax-exempt characteristics of individual bonds.

## MUNICIPAL BONDS: FREQUENTLY ASKED QUESTIONS

### Question (Q): What are the different types of municipal bonds?

Answer (A): By and far, municipal bonds fit into two categories:

- **Revenue bonds** repay bondholders using revenues from the project the bond initially financed, such as toll road collections or university tuition payments. Revenue bonds are typically issued by transportation authorities, universities, utilities systems, sports authorities, or any other agency managed like a business.
- **General obligation bonds** are backed by the “full faith and credit”—as well as taxing power—of the issuing governmental entity and can be repaid using revenue, income, or property taxes. If an instance occurs that threatens an issuer’s ability to pay back its bondholders, they have the authorization to use any available resources to repay—up to and including raising taxes. General obligation bonds are usually issued by states, cities, towns, and school districts. They typically fund infrastructure projects like the construction of roads, parks, and bridges, as well as the purchase of equipment.

### Q: What is the difference between a municipal bond and a municipal bond fund? Which one is right for me?

A: Municipal bonds are generally a single issue by a governmental agency or authority that, in most cases, you purchase at the beginning of the life of the bond. In return, you’re paid regular interest payments until the bond matures, at which point the principal is returned to you.

A municipal bond fund is a series of bonds invested in by a fund. Generally, with bond funds, a fund manager will research individual bonds that meet the criteria and goals of their fund, and buy and sell them as needed. Also, fund managers rarely keep a bond until it matures since they have to sell their securities in order to meet their financial obligation to their investors.

The product most suitable for your portfolio depends on your individual investment goals and risk tolerance.

**Q: Municipal bonds sound great. But what are the real risks?**

A: Investors should have a clear understanding of all the risks involved when investing in municipal bonds. Here are the primary risks for municipal bond investments:

- **Interest rate risk.** Bond prices and interest rates move in opposite directions. If interest rates are falling or expected to fall, investors will purchase previously issued bonds that feature a lower rate, increasing the price of those bonds. In this case, if an investor plans to sell their bonds, they may receive more than the par value. Conversely, if interest rates rise or are expected to rise, investors will sell the bonds they have at a lower rate and purchase the higher market rate bonds, causing prices of previously issued bonds to fall. In this case, if an investor plans to sell their bonds, they may not receive the full par value.
- **Call and reinvestment risk.** If a bond is “callable,” an issuer reserves the right to redeem the bond (or pay off their debt to bondholders), prior to maturity after a pre-determined number of years. In many cases, issuers will redeem a bond early if they have the ability to pay off their debt early or to save on interest expense. While callable bonds will offer higher interest or coupon rates to attract investors, bondholders run the risk of losing interest income and may have to scramble to find another investment that provides them with the same level of income.
- **Inflation risk.** Inflation is essentially an increase in prices. When inflation increases at a speed that exceeds the fixed rate of return of a bond investment, it can achieve a negative rate of return, lowering its overall market value.

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While bond mutual funds may offer investors greater diversification than an investment in a single bond investment, the underlying portfolio of the fund is still subject to the same interest rate risk of individual bonds, which can adversely affect performance. Bond funds are subject to the interest rate, inflation, and credit risks associated with the underlying bonds in the fund.

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- **Credit and default risk.** Despite credit ratings and credit quality, an issuer could default on their bond issuance. Although this is not probable—according to a 2016 report by Moody’s, only 0.18 percent of investment-grade municipal bonds have defaulted.<sup>5</sup>
- **Rating downgrades.** While most bonds and issuers receive credit ratings prior to issuing bonds, those ratings are subject to change. Rating agencies track issuers and previous bonds issued. If economic, operational, or sector-specific circumstances stand to affect established credit risks, agencies can downgrade their rating, which may impact the issuer’s ability to pay its debts as well as an investors’ ability to sell their bonds in the secondary market.
- **Liquidity risk.** Many investors choose to hold their bonds to maturity. As result, this decreases the liquidity of a particular bond, making it difficult for an investor to buy or sell their bonds at a specific price and time.

**Q: Are there any useful investment strategies when it comes to bonds?**

A: When investing in municipal bonds, you and your financial professional can deploy a number of strategies to help make the most of your principal, including:

- **Bond laddering** is the process of strategically allocating your money into differing individual bonds with varying maturity dates. These bonds are typically short-, mid-, and long-term bonds. This strategy provides you with consistent interest income throughout the life of the bonds as well as expected principal repayments at defined intervals. When a bond matures, you can reinvest in a longer-term bond to continue the ladder.
- **Bond barbell** is similar to laddering, with the exception that you’re investing in only short-term and long-term bonds. If interest rates rise, you can reinvest the bonds that are maturing earlier into higher-yield bonds. Conversely, if interest rates fall, you’ll have long-term bonds with interest rates locked in for the life of the bond.

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<sup>5</sup> U.S. Municipal Bond Defaults and Recoveries, 1970-2016. (2017). Moody’s.

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- **Bond swapping** is the process of selling current bonds held in a portfolio and replacing them using the proceeds of that sale. There are many reasons an investor would deploy this strategy:
  - **Tax swap.** Investors can offset capital gains taxes by swapping bonds toward the end of the year and write off the losses.
  - **Interest rate swap.** Investors can also take advantage of changing interest rates with bond swapping. In a falling interest rate environment, investors can swap the bonds they hold at a premium with new bonds that have a similar yield and purchase them at par. In a rising rate environment, investors can swap bonds with a lower coupon for bonds with a coupon rate that matches the markets' higher interest rates.
  - **Maturity swap.** Investors can also swap bonds to shorten or lengthen the maturities of the bonds they hold. If interest rates fall, investors can swap bonds with shorter maturities for longer ones in order to take advantage of rising prices. Swapping for a bond with a longer maturity may also increase yield. Conversely, if interest rates rise, swapping bonds with longer maturities for shorter ones can help stabilize the price of a bond.
  - **Credit swap.** Finally, investors can swap bonds with lower credit ratings for bonds with higher credit ratings to provide downturn protection. While the overall yield may be lower, the decreased chance of issuer default offsets the reduced payments.



## MUNICIPAL BONDS: KEY CONCEPTS

Every investor should understand the different characteristics of municipal bonds before purchasing them. The following are the primary features and pricing considerations common to most municipal bonds:

- **Bond price.** The amount you pay to buy a bond, which can be priced three different ways: at par (the amount of principal you'll receive when the bond matures), at a discount (a bond priced below par, when an investor pays less than face value), and at premium (a bond priced above par, when an investor pays more than face value).
- **Call provisions.** When a state or local government redeems a bond at a specific price prior to its stated maturity date. When an issuer exercises a call, you receive the principal amount of the bond and may be eligible for an additional premium.
- **Interest.** Also referred to as the coupon rate, interest is the annual rate as a percentage of principal that you will receive on a bond, not counting any discount or premium in purchase price.
- **Interest payment date.** When you can begin receiving interest payments on a bond.

- **Maturities.** Bonds are issued in maturities ranging from one to 30 years. Some bonds, called Serial Bonds, are issued with a series of scheduled maturity dates, while other bonds, called Term Bonds, are issued with a single maturity.
- **Minimum investment.** Investing in municipal bonds requires a high minimum investment compared to corporate bonds and stocks. On average, the minimum investment is \$5,000 with additional bonds sold in \$5,000 increments.
- **Bond rating.** Municipal bonds receive ratings (or credit risk evaluations) from several different rating agencies, including Moody's Investors Service, S&P Global Ratings, and Fitch Ratings. In order to assign a rating, these agencies assess the current economy, the structure of the issuance, and the financial condition, demographics, and management practices of the issuer.
- **Tax status.** The Internal Revenue Code excludes most municipal bonds from gross income for tax purposes. While bonds are tax-exempt in many cases, they're still subject to some tax implications and you should speak with your tax advisor to get a more accurate picture of how they can impact your tax return. It's also important to note that some states tax their own bonds.
- **Yield.** The annual return you will receive on a bond taking into account the purchase price. Yield is also expressed as yield-to-maturity (the amount of money you receive from payments of principal and interest if the bond is held to maturity) and yield-to-call (the rate of return you earn from principal and interest payments in the case that the bond is redeemed on its specified call date).

# MUNICIPAL BOND RATINGS

In most cases, municipal bonds and their issuers receive credit risk evaluations prior to issuance and periodically throughout their lifespans. Issuers request and pay for these evaluations, which are completed by bond rating agencies—commonly, Moody’s Investors Service, S&P Global Ratings, and Fitch Ratings. While these ratings help inform investors about the risk involved in their investment, they also play a big part in the interest rates issuers pay on their bonds.

Different ratings agencies confer different ratings, so it’s important to understand their rating scales. Below is a breakdown of the credit rating scale for the three most common bond-rating agencies:

CREDIT RATING AGENCY SCALE COMPARISON <sup>6</sup>			
BOND QUALITY	MOODY’S INVESTORS SERVICE	S&P GLOBAL RATINGS	FITCH RATINGS
Best quality	Aaa	AAA	AAA
High quality	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
Upper medium grade	A1	A+	A+
	A2	A	A
	A3	A-	A-
Investment grade	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Speculative	Ba	BB	BB
	B	B	B
	Caa	CCC	CCC
	Ca	CC	CC
	C	C	C
			D (default)

6 Credit Rating Basics for Municipal Investors. (2018). Municipal Securities Rulemaking Board.

**Non-rated municipal bonds**

Some municipal bonds are not rated by credit rating agencies. While some non-rated bonds have the same credit quality of investment grade bonds, most of them are below investment grade and thus considered high-yield investments.

However, that doesn't mean a non-rated bond can't have a place in your portfolio. In fact, non-rated muni bonds have existed for decades and continue to be traded every day. Oftentimes, bonds are not rated simply because issuers don't believe the rating will impact their borrowing rates enough to incur the time and expense associated with the rating process. Other bonds are not rated merely because they are part of a small municipal sector and the agencies do not have the controls and methods to effectively rate them.

Investing in non-rated bonds might be a good option for aggressive investors who are looking for higher yields. However, as with most investments, we recommend you speak with a financial professional to make sure these investments align with your risk tolerance and time horizon.

**YOUR GO-TO MUNICIPAL BOND SOURCE**

Investing in municipal bonds can provide you with many benefits—from preserving wealth and establishing a predictable source of income, to offsetting increased tax bills and helping your loved ones and favorite charitable organizations become financially independent.

However, as with any investment, you should consider all the variables. A HilltopSecurities financial professional can help ensure your investment decisions align with your overall financial goals.

**ABOUT HILLTOPSECURITIES**

As a leading municipal investment bank, HilltopSecurities has helped municipalities, states, and nonprofits issue municipal bonds and other fixed income products to finance vital infrastructure projects since 1949.

Our active participation in the primary and secondary bond markets provides your financial professional with the deep insight and access they need to advance your fixed income portfolio.





## CONTACT US

Find out if municipal bonds are a good option for your portfolio. Contact us today.

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As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance. The principal value of bonds and bond funds fluctuates with changes in market conditions. When sold, they may be worth more or less than their initial cost. Investment income from municipal bonds may be subject to the alternative minimum tax (AMT), and capital appreciation from discounted bonds may be subject to state or local taxes. Capital gains are not exempt from federal income.

Fixed income investments are subject to various risks including changes in interest rates, credit quality, inflation, market valuations, prepayments, corporate events, tax ramifications, and other factors.

Specific bonds differ in their sensitivity to changes in interest rates depending on their individual characteristics, including duration. Call risks: Declining interest rates may accelerate the redemption of a callable bond, causing an investor's principal to be returned sooner than expected.

Bond funds are sold by prospectus. Consider the investment objectives, risks, charges, and expenses of the investment company carefully before investing. The prospectus contains this and other information about the investment company. Prospectuses may be obtained from the investment company or from your registered representative. Please read the prospectus carefully before investing.

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