Exploring Municipal Bonds: The potential benefits of tax-exempt income

Income taxes have a tremendous impact on how hard your investment dollars work for you.

Depending on individual circumstances, much of your investment return may go to federal and state taxes. Income generated from tax-exempt municipal bonds and tax-exempt municipal bond funds is an option available to investors that is not subject to federal income taxes[1].

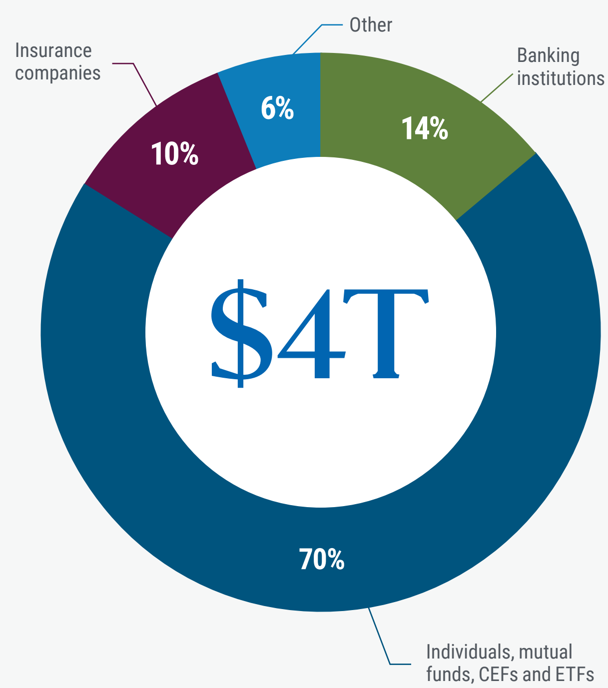
REVIEWING DIFFERENT TYPES OF MUNICIPAL BONDS

Municipal (muni) bonds are debt obligations issued by government entities that use the loans to fund public projects such as the construction of schools, hospitals, and highways.

Muni bonds fall into two categories – general obligation bonds (GOs) and revenue bonds. While muni bonds are available in both taxable and tax-exempt formats, the tax-exempt bonds can often attract attention because the income they may generate is often exempt from federal taxes and, in many cases, is exempt from state and local income taxes.

- **General obligation bonds (GOs)**
  GOs are issued by governmental entities but they are not backed by revenues from a specific project, such as a toll road. Some GOs are backed by dedicated taxes on property, while others can be payable from general funds.
- **Revenue bonds**
  The principal and interest payments for revenue bonds are secured by revenue generated by the issuer or by certain taxes such as sales, fuel or hotel occupancy taxes. Issuers of revenue bonds are generally non-profit organizations, private-sector corporations (e.g. hospitals, universities, etc.), and entities providing a public service (e.g. utilities, public transportation, etc.).

The Muni Market is largely driven by retail investors[2]



2 Source Federal Reserve, as of 31 March 2024

1 Income from **municipal bonds** is exempt from federal income tax and may be subject to state and local taxes and at times the alternative minimum tax.

UNDERSTANDING THE TAX-EQUIVALENT YIELD

The tax-equivalent yield is the return that a taxable bond would need to equal the yield on a comparable tax-exempt municipal bond. The calculation below is used to compare the returns between a tax-exempt investment and a taxable alternative.

$$\text{Tax equivalent yield} = \frac{\text{Tax-exempt municipal bond yield}}{1 - \text{Marginal tax rate}}$$

To determine whether tax-exempt income means you may be able to retain more of your earnings: 1) Locate your taxable income and marginal tax bracket on the chart, and 2) find the taxable equivalent yields that you would need to match income at various tax-exempt yields.

			Tax-exempt bond yield						
			2.0%	2.5%	3.0%	3.5%	4.0%	4.5%	5.0%
Single income	**Married Filing Jointly income**	**Marginal tax rate**	**Taxable equivalent yield**						
$0-$11,600	$0-$23,200	10%	2.22%	2.78%	3.33%	3.89%	4.44%	5.00%	5.56%
$11,600-$47,150	$23,200-$94,300	12%	2.27%	2.84%	3.41%	3.98%	4.55%	5.11%	5.68%
$47,150-$100,525	$94,300-$201,050	22%	2.56%	3.21%	3.85%	4.49%	5.13%	5.77%	6.41%
$100,525-$191,950	$201,050-$383,900	24%	2.63%	3.29%	3.95%	4.61%	5.26%	5.92%	6.58%
$191,950-$243,725	$383,900-$487,450	32%	2.94%	3.68%	4.41%	5.15%	5.88%	6.62%	7.35%
$243,725-$609,350	$487,450-$731,200	35%	3.08%	3.85%	4.62%	5.38%	6.15%	6.92%	7.69%
$609,350+	$731,200+	37%	3.17%	3.96%	4.76%	5.56%	6.35%	7.14%	7.93%

Hypothetical Example for Illustrative Purposes Only.
As of 31 July 2024. Source: PIMCO

CONCEPT IN PRACTICE

Consider this example: a married couple has a taxable income of $400,000; they fall into the 32% tax bracket. For this couple, they would need a *taxable bond* to earn 5.88% to match a 4.0% yield from a *tax-exempt* bond.

HOW TO INVEST IN MUNI BONDS

Investors have multiple options when considering ways to invest in munis.

- **Individual bonds** — Investors, along with their financial professional, may research and select individual municipal bonds for purchase based on risk, return, maturity date, state-specific characteristics, etc. Using a "buy-and-hold" strategy, investors can hang onto the bonds until maturity in their portfolio.

- **Muni bond ladders** — Together with a financial professional, investors can research and purchase individual municipal bonds with staggered maturities (e.g. 1, 3, 5, 10, 20, 30 year maturities) to build a ladder in a portfolio that provides a stream of regular income that fits their cash flow needs.

- **Muni bond funds and ETFs** — For investors who are not comfortable selecting individual municipal bonds on their own, a well-diversified muni fund or ETF may be appropriate. A fund that invests in bonds across municipalities with different credit ratings, bond types, and various risk/return profiles can help diversify your muni allocation rather than concentrate a portfolio in one issuer. In addition, investors may want to consider state-specific funds to potentially benefit from both federal and state and local tax exemption.

- **Muni bond Separately Managed Accounts (SMAs)** — Investors can customize a SMA to seek greater flexibility for their portfolio, including the potential for greater tax efficiency and specific state-focused portfolios.

- **Closed-end fund (CEF)** — Type of mutual fund that issues a fixed number of shares through a single initial public offering (IPO) to raise capital for its initial investment. Shares are then bought and sold on an exchange (between buyers and sellers) but no new shares are created or redeemed by the fund manager (unlike traditional open-ended funds) and no new money will flow into the fund. Since shares trade on exchanges, these funds often trade at a premium or a discount from their net asset values (NAV). Many municipal CEFs are actively managed and attempt to maximize tax-exempt income to potentially provide investors with higher distributions.

- **Interval fund** — An interval fund is a type of closed-end fund that is not listed on an exchange. Interval funds periodically offer to repurchase a limited percentage of outstanding shares from their shareholders. Interval funds focused on the municipal bond space can provide investors with access to privately issued, less liquid muni bonds in an attempt to enhance risk-adjusted returns.

SOME PLANNING CONSIDERATIONS

When pursuing optimized after-tax returns for bonds, consider the following:

- Lower income taxpayers may often benefit from taxable bonds, and higher income taxpayers may benefit from tax-exempt bonds.

- Income investors may want to compare after-tax return on taxable bond to municipal bond yield. Growth investors may want to compare total return on taxable and tax-exempt bonds.

A WORD ABOUT RISK

Like all fixed income securities, municipal bonds are susceptible to similar risks including, but not limited to:

- **Interest rate risk** — the potential for investment losses that can be triggered by a move upward in rates for new bonds. If interest rates rise, market prices for existing bonds will typically decline. Bonds with longer maturities are generally more susceptible to changes in interest rates than bonds with shorter maturities.

- **Call risk** — the risk that the municipal bond issuer will redeem the bond prior to the maturity date. This means the bondholder will receive payment on the value of the bond and in some cases will be reinvesting in a less favorable environment with a lower interest rate.

- **Liquidity risk** — refers to the marketability of the bond and whether it can be bought or sold quickly enough to meet obligations. The majority of municipal bonds are not traded on a regular basis and therefore the market for a particular municipal bond may not be particularly liquid given the large number of municipal issuers and variety of securities that make up the municipal bond market.

- **Default risk** — the risk that an issuer (e.g. municipality) will be unable to make required principal or interest payments.

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Pacific Investment Management Company LLC, 650 Newport Center Drive, Newport Beach, CA 92660 | 800.387.4626

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