



Generating Tax-Free Income

Municipal bonds offer tax benefits and attractive yield potential to fixed income investors.

Municipal bonds issued by state and local governments provide investors with tax-free income potential and the benefits of diversification—important aspects of a long-term investor’s portfolio. Although there have been occasional bouts of stress for the asset class from factors such as the global financial crisis, concerns about tightening monetary policy, and news about troubled issuers like Detroit

KEY POINTS

- Munis can provide a potential income stream that is tax-free at the federal level.
- The two main types, general obligation bonds and revenue bonds, carry different risks.
- Munis traditionally have a low default rate and offer diversification benefits to investor portfolios.

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and Puerto Rico, investor demand for municipal bonds has been robust in recent years. One reason for munis’ staying power: It is rare for a municipality to default or miss an interest or principal payment to bondholders.

What’s more, municipal bonds’ tax and diversification benefits provide investors with longer-term advantages. “The tax advantages and regular income mean that investors in every tax bracket should consider whether munis might be a good fit for the fixed income portion of their portfolios,” says Hugh McGuirk, head of municipal bond investing at T. Rowe Price.

Understanding munis

Municipal bonds are tax-exempt debt obligations issued by cities, counties, states, and other governmental entities. They are used to fund infrastructure projects, essential services, and other projects that serve the public interest. There are two main types of munis: general obligation bonds and revenue bonds. General obligation bonds are backed by the issuer’s ability to raise money through taxes and include projects such as schools and roads. Revenue bonds are issued by a government-related entity to fund a particular project, such as an airport or a hospital wing. Interest and principal payments to investors in revenue bonds are funded by the revenues generated by that project.

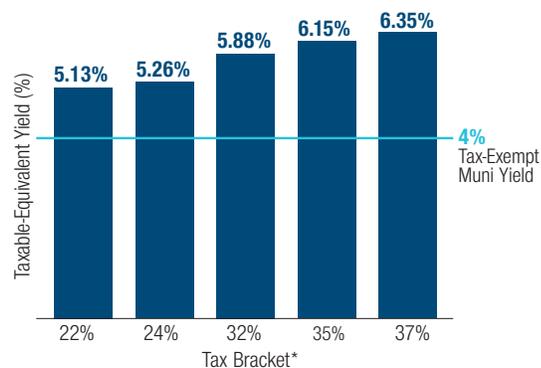
What they offer

Munis provide a potential income stream that is exempt from federal income taxes. Income from munis issued in an investor’s home state also typically is exempt from state income taxes. The value of this tax benefit depends on your tax situation and is highest for investors in higher tax brackets or those who live in high-tax jurisdictions. Furthermore, these tax advantages are most useful when munis are held in taxable accounts. The reason: When you compare munis with taxable bonds that offer comparable maturities, munis’ yields typically are lower than the pretax yields on taxable bonds. (See “A Primer on Taxable-Equivalent Yield.”) It is important to note that some income may be subject to state and local taxes and the federal alternative minimum tax.

Investors can choose from a diverse array of muni issues, which vary in purpose, maturity, and yield. Consider investing in municipal bond mutual funds—also known as tax-free bond funds—rather than targeting individual securities to achieve greater diversification.

A Primer on Taxable-Equivalent Yield

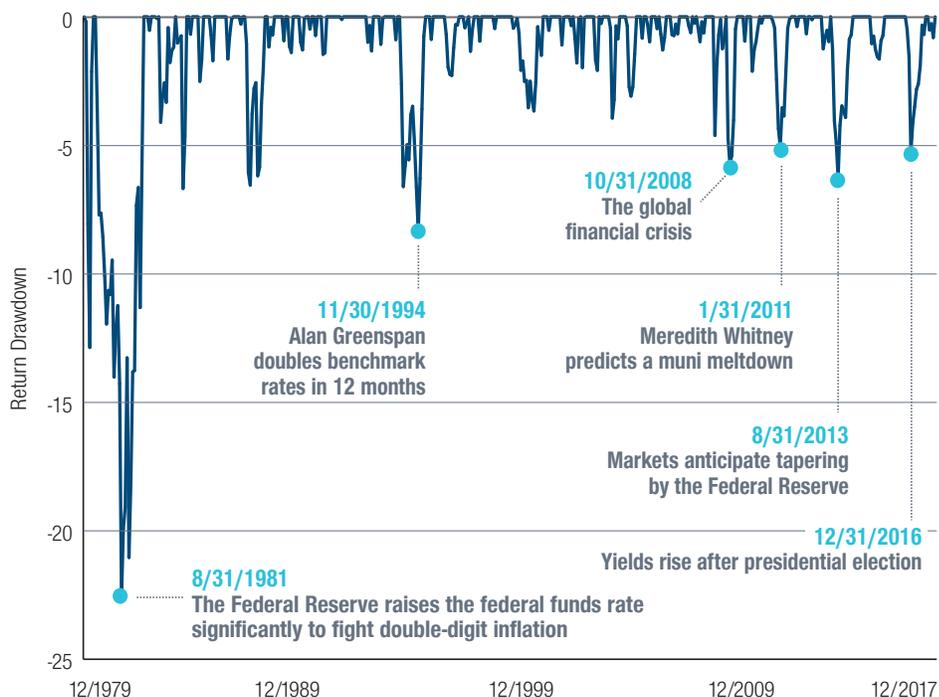
Municipal bonds offer tax-free income, which means investors are often willing to accept a lower yield compared with the pretax yield on a similar taxable bond. When you are making a decision on how to allocate your investment dollars, make sure you are comparing the right numbers. Select your federal tax bracket to see the pretax yield you would have to earn on a taxable bond to equal a 4% tax-free yield on a municipal bond.



*Does not include the 3.8% Net Investment Income Tax; see irs.gov for more information.

Muni Bond Sell-Off and Recovery

Market forces can prompt investors to sell off their muni holdings, as the chart below demonstrates. However, the muni market has been resilient, bouncing back quickly after such events.



Source: Bloomberg Barclays Municipal Bond Return Drawdowns.

The tax-free income generated by munis can benefit investors in all tax brackets. Munis can also provide valuable diversification benefits in an investment portfolio.”

– HUGH MCGUIRK,
HEAD OF MUNICIPAL
BOND INVESTING

Such funds enable investors to benefit from the expertise of professional managers and analysts who perform essential credit research and navigate a changing market effectively. For example, a special team of T. Rowe Price analysts identified Puerto Rico’s municipal bond risks a year before the commonwealth’s financial problems were widely publicized and long before the bonds were downgraded. Of course, diversification cannot assure a profit or protect against loss in a declining market. All mutual fund investments are subject to market risk, including the possible loss of principal.

Know the risks

Like other investments, municipal bonds carry certain risks. For instance, there is a risk that interest rates will rise, causing bond prices to drop. Although rates have defied expectations and remained below long-term averages in recent years, a stronger economy could lead the Federal Reserve to move rates higher. That said, many of today’s muni investors are focused on credit risk, especially in light of headlines about the fiscal problems of Puerto Rico and some other muni bond issuers.

Credit risk represents the potential that a bond issuer will fail to make timely interest and principal payments to its bondholders, thereby resulting in a default. Municipal bankruptcies have been rare, though, and when defaults have occurred, they represented a minuscule portion of a large market. In a study by Moody’s Investors Service, the ratings agency found that the 10-year cumulative default rate for all rated municipal

credits was 0.15% over the 1970–2015 period. In contrast, the cumulative default rate for all rated corporate issuers was 10.16%. What’s more, the muni market typically recovers quickly following an event that pushes investors away from munis. (See “Muni Bond Sell-Off and Recovery on page 3.”)

Although the market is overwhelmingly high quality, many states and municipalities are struggling with underfunded pensions and other post-employment benefit (OPEB) obligations, and the market has begun to price in higher pension risks as the magnitude of unfunded liabilities becomes more conspicuous. As a result, T. Rowe Price portfolio managers favor bonds backed by a dedicated revenue stream over general obligation bonds, as revenue bonds have less exposure to the pension funding concerns facing state and local governments.

Regardless of market conditions, municipal bonds continue to play an important role in a well-designed fixed income portfolio. “The tax-free income generated by munis can benefit investors in all tax brackets,” McGuirk says. “Munis can also provide valuable diversification benefits in an investment portfolio.” ■

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