Why Investors Should Consider Taxable Municipal Bonds

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There's a small portion of the bond market that investors may have overlooked in the past, but should now consider—the taxable municipal bond market.

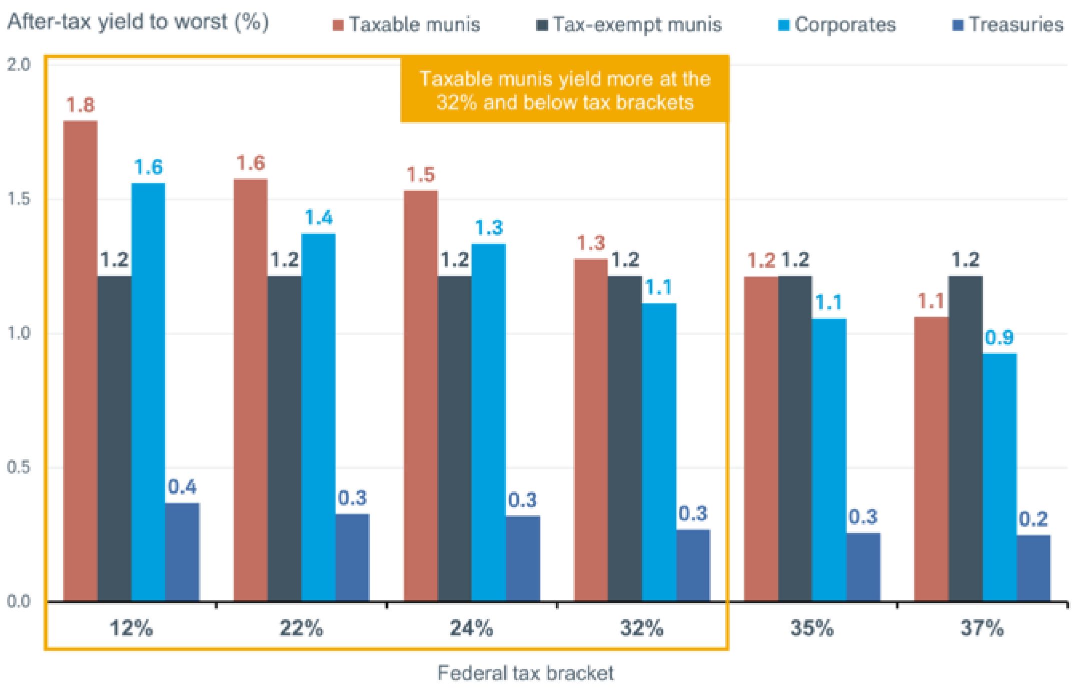
Most munis pay interest that is exempt from federal and potentially state income taxes. However, interest on some municipal bonds is subject to both federal and state income taxes. These bonds, known as taxable municipal bonds, generally pay higher interest rates than tax-exempt munis to make up for the lack of tax benefits.

Today, taxable municipal bonds look attractive to us because they offer higher yields without having to take on too much additional credit risk. Issuance of taxable munis also has increased—meaning more selection, which is helpful for diversification. Below are some of the primary reasons we think investors should consider taxable munis.

1. Taxable munis offer attractive yields relative to other fixed income investments.

Yields for taxable municipal bonds are attractive, in our view, relative to many other fixed income investments. As illustrated in the chart below, even after adjusting for taxes, taxable munis offer higher yields compared to tax-exempt munis for taxpayers in the 32% and below brackets. They also yield more than corporate and Treasury bonds at all tax brackets. It's important to note that these yields are based on indices, and there may be differences when comparing individual bonds.

After-tax yield comparisons for different bonds at various tax brackets



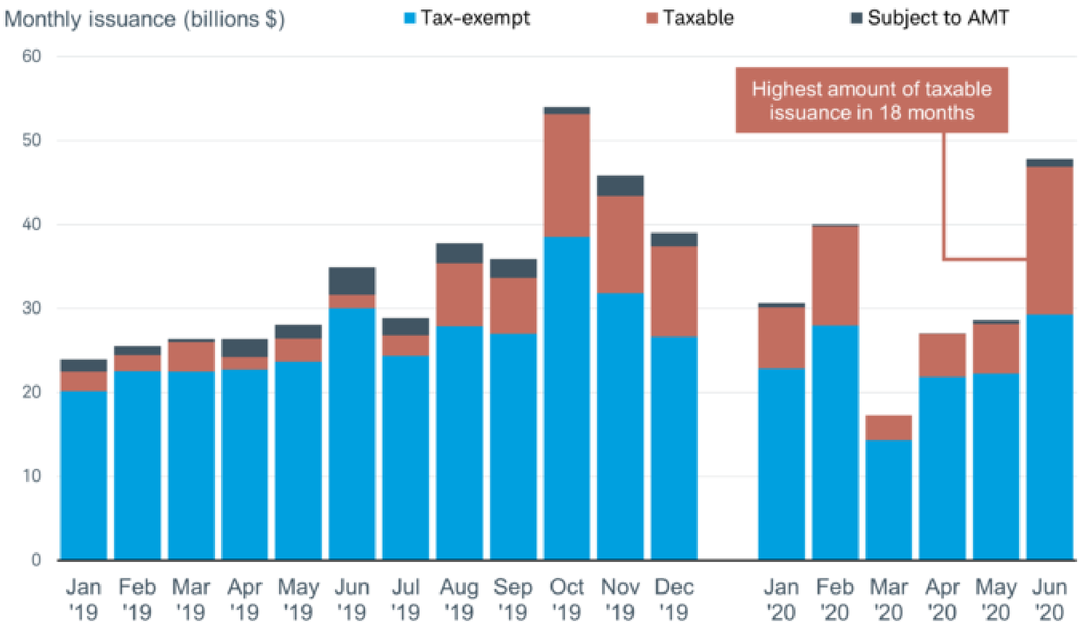
Source: Bloomberg Barclays US Municipal Bond Index, Bloomberg Barclays US Taxable Municipal Bond Index, Bloomberg Barclays US Corporate Bond Index, and Bloomberg Barclays US Treasury Bond Index, as of 7/28/2020. Corporates and taxable munis assume an additional 5% state income tax and 3.8% ACA tax for the 32% and above brackets. Treasuries assume a 3.8% ACA tax for the 32% and above brackets. Difference in yields may be due to index characteristics such as duration, maturity, or credit quality. After-tax YTW (yield to worst) is the lowest potential yield you may receive from a bond, assuming the issuer does not default. **Past performance is no guarantee of future results.**

2. Issuance of taxable munis has increased.

One of the reasons that taxable munis are attractive today is because issuance has surged, which gives investors more options to choose from—although the taxable muni market overall remains relatively small compared with other types of bonds (more on that below). The increase in issuance makes diversification easier.

Issuance has increased largely because issuers have been refinancing older, higher-yielding tax-exempt debt and replacing it with taxable debt at lower rates. Prior to the Tax Cuts and Jobs Act of 2017, issuers would have used tax-exempt debt, but the tax law changes restricted this practice.

Taxable bond issuance rose in June



Source: Securities Industry and Financial Markets Association (SIFMA), as of 7/2/2020

3. Taxable munis are generally high in credit quality, like other munis.

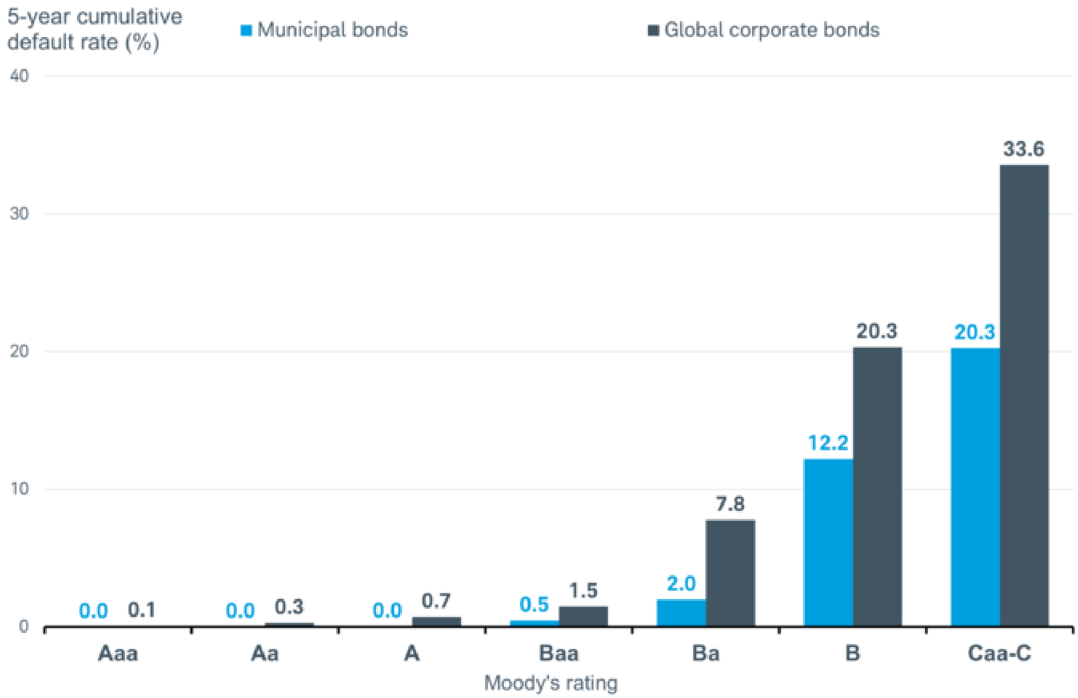
Another potential benefit of taxable munis is that they're generally higher in credit quality than other alternatives. For example, 78% of the taxable muni market is rated in the top two rungs of credit quality. This compares to 72% for the tax-exempt muni market and only 7% of the corporate market.[1]

Two important points are illustrated in the chart below. First, higher-rated issuers tend to default—that is, to miss an interest or principal payment—less frequently than lower-rated issuers. For example, over a five-year period ending in 2019, 0.5% of Baa rated munis defaulted, according to Moody's Investors Service. During the same period, lower-quality B rated munis defaulted 25 times more frequently, at a rate of 12.8%.

Second, municipal bond issuers, which include issuers of taxable munis, tend to default less frequently than corporate bond issuers. Looking at the Baa rated cohort, the default rate for munis was 0.5%, compared with 1.6% for corporates.

The bottom line is that yields for taxable munis are higher than most taxable alternatives, yet you generally don't have to accept greater credit risk to get those higher yields.

Default rates are lower for munis compared to corporates



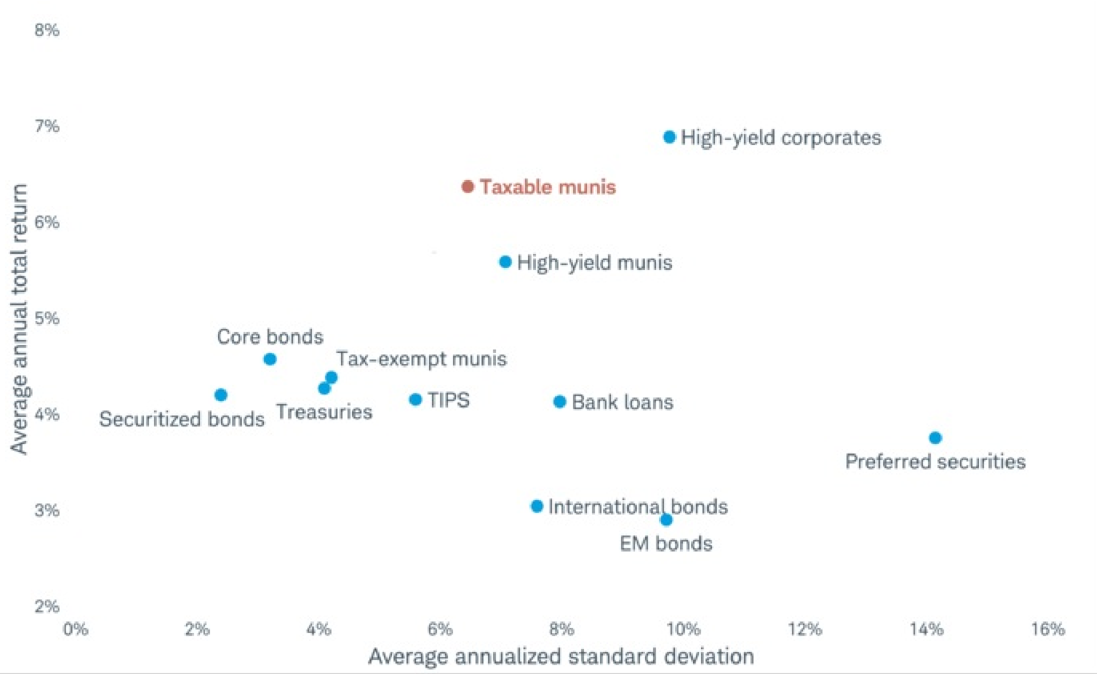
Source: Moody's Investors Service, as of 7/15/2020

4. The longer-term risk-and-reward characteristics of taxable munis are attractive, in our view.

For investors in high tax brackets, we generally don't see value in taxable munis. However, investors in lower tax brackets or those investing a tax-sheltered account like an individual retirement account (IRA) may want to consider a small allocation to taxable munis to complement their other fixed income holdings.

As illustrated in the chart below, returns for taxable munis historically have been high compared to other, riskier parts of the fixed income markets relative to their volatility (or standard deviation). Note that future returns for taxable munis could be lower, due to lower yields today compared with historical averages.

Taxable munis historically have had attractive returns relative to their risk



Note: Standard deviation is a measure of the amount of variation or dispersion of a set of values. A low standard deviation indicates that the values tend to be close to the mean of the set, while a high standard deviation indicates that the values are spread out over a wider range.

Source: Bloomberg Barclays Indices, monthly data from 1/31/2006 to 6/30/2020. Data for emerging market (EM) bonds begins on 6/30/08 due to index limitations. **Treasuries** = Bloomberg Barclays US Treasury Bond Index; **Taxable munis** = Bloomberg Barclays US Taxable Municipal Bond Index; **Securitized bonds:** Bloomberg Barclays US Securitized Bond Index; **Core bonds** = Bloomberg Barclays US Aggregate Bond Index; **Tax-exempt munis** = Bloomberg Barclays Municipal Bond Index; **High-yield munis** = Bloomberg Barclays High Yield Municipal Bond Index; **TIPS** = Bloomberg Barclays US Treasury Inflation Notes Index; **International bonds** = Bloomberg Barclays Global Aggregate ex-USD Index; **Corporate bonds** = Bloomberg Barclays US Corporate Bond Index; **Preferred securities** = ICE BofA Fixed Rate Preferred Securities Index; **EM bonds** = Bloomberg Barclays EM Local Currency Bond Index; **Bank loans** = S&P/LSTA U.S. Leveraged Loan 100 Index; **High-yield corporates:** Bloomberg Barclays US Corporate High Yield Index. **Past performance is no guarantee of future results.**

However, it's important to note that taxable munis aren't without risks. Here are two of the most prominent risks:

1. The taxable muni index is sensitive to interest rate changes.

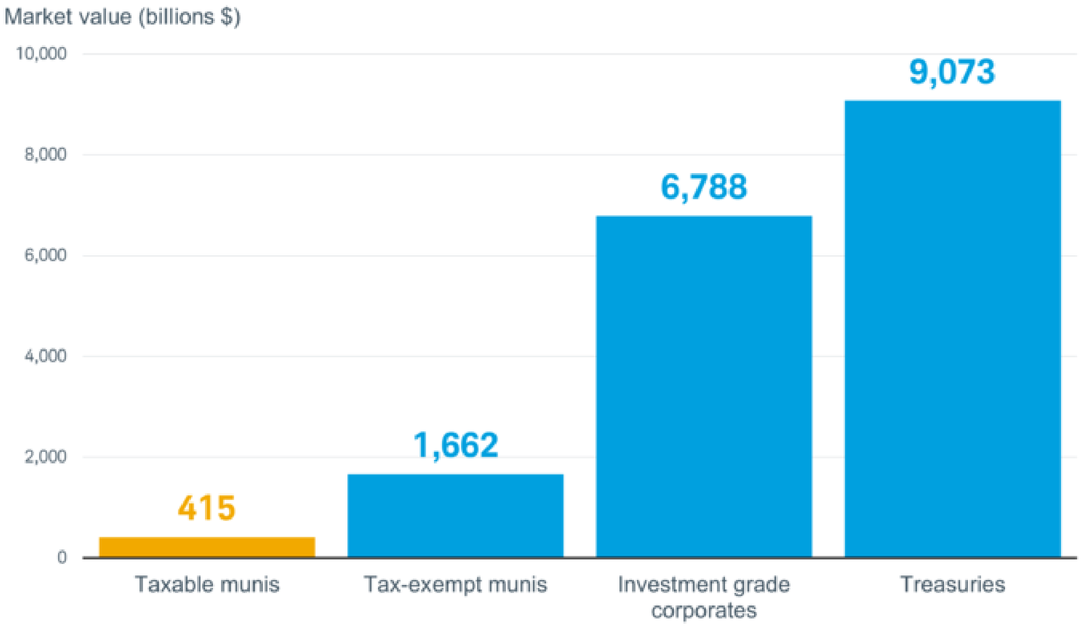
First, the taxable muni index has a longer average duration—which makes it more sensitive to changes in interest rates—than the tax-exempt index. For investments such as exchange-traded funds (ETFs) or passively managed mutual funds that simply track the index, investors are taking on greater interest rate risk with taxable munis compared to tax-exempt munis. We expect rates to stay lower for a long time, due to a combination of Federal Reserve policy and the coronavirus crises weighing on growth concerns. However, if rates rise more than we expect, total returns for taxable munis would likely underperform their tax-exempt counterparts.

2. The relatively small size of the market is a risk.

Although issuance has risen recently, the taxable muni market remains a much smaller market than many other fixed income markets, as illustrated in the chart below. A smaller market is generally less liquid than a much larger one, like the Treasury market, which means that it can be more difficult to sell your bond if you need to. Therefore, we suggest investors who are considering taxable munis plan on holding them until maturity. The smaller market and lower liquidity of taxable munis is also an issue for investors in funds like ETFs or mutual funds. Bonds that are less liquid are generally more volatile in times of market stress.

In addition to being less liquid, a smaller market makes it more difficult to achieve adequate diversification. The recent increase in taxable issuance means there are more options to select from than in the past, but again, it's still a relatively small market. We suggest investors in individual bonds invest in at least 10 different issues with differing credit risks. This is harder the smaller the market.

The size of the taxable muni market can pose additional risks



Source: Bloomberg Barclays Indices, as of 7/31/2020

What to consider now

Yields for many fixed income investments are historically low, but taxable munis may be one area investors want to consider to achieve potentially higher yields. Investors who are using a tax-sheltered account may want to consider them, as well. Usually munis don't make sense for a tax-sheltered account, but taxable munis are an exception.[2]

Schwab clients can log in to their accounts and search for individual taxable munis using the "Federally Taxable" dropdown menu under "Search by Product" on Schwab Bond Source on Schwab.com. Clients can also search for funds like ETFs or mutual funds on Schwab.com that invest primarily in taxable munis. If you need additional help, reach out to a Schwab Fixed Income Specialist for guidance in selecting the investments that are right for you.

[1] As represented by the Bloomberg Composite Rating for the Bloomberg Barclays US Municipal Bond Index, the Bloomberg Barclays US Taxable Municipal Bond Index, and the Bloomberg Barclays US Corporate Bond

Index, as of 7/29/2020.

[2] Tax-exempt munis usually pay a lower rate of interest because the interest income they pay is generally not subject to federal or state income taxes. However, interest income is not taxed in a tax-sheltered account when it is received.

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