



# Seven Questions to Ask When Investing in Municipal Bonds

Potential investors in municipal bonds may have many questions when considering the purchase of a municipal security. The following information can serve as a starting point for a discussion with a financial professional, typically referred to as a broker, about investing in municipal securities.

## 1. What Information Is Available about a Municipal Bond?

Before investing in a municipal bond, an investor should carefully review the information available about the bond. Key sources of information, all of which are available on the MSRB's Electronic Municipal Market Access (EMMA®) website at [emma.msrb.org](http://emma.msrb.org), include:

- **Official Statements** — These documents are disclosures made available by state and local governments that contain terms of a bond and other details such as credit ratings and financial information about the state or local government. When bond proceeds are used to make loans to other parties (such as hospitals or universities), the bond issues are generally secured by the loan payments, and the official statements contain financial disclosure about the borrowers, sometimes referred to as "obligated persons."
- **Continuing Disclosures** — Ongoing disclosures released throughout the life of a bond may provide information such as the state or local government's or obligated party's annual financial statements, as well as changes in financial conditions and other events

that could affect the value of a bond, such as credit rating changes.

- **Trade Prices** — Trade prices can provide a valuable basis for evaluating the price of a bond investment.

Brokers are required to disclose to potential investors any information available from established industry sources that may be material to an investment. Investors should ask their broker whether they are being provided with the full range of information they are entitled to receive and any additional information that they should consider when making a decision to invest in a municipal security.

## 2. What Should I Know About Credit Quality?

Investors should ask their broker to help them understand a bond's credit quality. Credit quality is an important factor that brokers must consider in determining whether a bond is suitable for an investor's strategy and risk appetite. Investors should discuss the bond's source of repayment, priority of payment and credit rating with their broker.

**Source of Repayment** — An important factor in a bond's credit quality is the source of repayment for the bond. There are three main sources of repayment,



Review real-time price information on the EMMA website.

and bonds are classified by the following sources:

- **General Obligation** — A general obligation bond is paid through any revenues the state or local government receives. This type of bond is also sometimes known as a “full faith and credit” bond. In most cases, the state or local government has agreed to levy taxes in an amount sufficient to make payments of principal and interest on outstanding bonds.
- **Revenue Bond** — A revenue bond is repaid from the revenues of the project or system that the bond is financing rather than the state or local government’s general funds.

**Priority of Payment** — To understand credit quality, investors should also discuss with their broker whether other obligations of the state or local government take precedence for payment. Investors should also understand the difference between senior debt, which is paid first, and subordinate debt, which is paid after senior debt is paid. Finally, investors should understand whether funds for the payment of a bond must be appropriated annually by the state or local government — known as “subject to appropriation.” A bond’s official statement, which is available on the EMMA website, will indicate the sources and priority of payment.

**Credit Rating** — A bond’s credit rating is the evaluation or assessment that rating agencies such as Fitch Ratings, Kroll Bond Rating Agency, Moody’s Investors Service, Inc. and Standard & Poor’s assign to a security to indicate likelihood of default and, in some cases, takes into consideration the potential loss to investors in the event of default. Investors

should be aware that credit ratings are one of many pieces of information that may be considered and should discuss with their broker other aspects that affect credit quality, including the likelihood that the state or local government will be able to make payments on the bond, credit enhancement or guarantee, and the credit of the bond insurer. Investors should also keep in mind that the credit rating may have changed since the bond was issued.

Current credit rating information for municipal securities provided by Fitch Ratings, Kroll Bond Rating Agency, Moody’s Investors Service, Inc. and Standard & Poor’s is displayed on the EMMA website for all individual municipal securities that have ratings assigned by the four agencies. These ratings may assist investors in evaluating the general creditworthiness of a particular bond.

### 3. What Should I Know About Yield?

Yield is the annual return an investor should expect on a bond. Investors should understand the various factors that affect yield. Yield will vary depending on how much the investor pays for the bond — the higher the price, the lower the yield. Investors can determine how the price and yield on a bond compare to recent trade prices of the same or similar bonds by reviewing real-time price information on the EMMA website. Yield will also vary with credit quality. Generally, higher yields mean lower credit ratings and greater risk. Investors should work with their broker to determine how yield affects their appetite for credit risk.

Yield will also vary with the maturity of the bond. Bonds with longer maturities usually pay higher interest rates than bonds



[Subscribe to investor education and EMMA email updates from the MSRB.](#)

*Tax considerations are especially important for municipal bond investors.*

with shorter maturities to account for the greater element of market risk over the longer life of the bond. Investors should discuss with their broker when they expect to need the principal amount of their bonds repaid.

If a bond must be sold before it matures, its value at the time of sale may be less than the investor paid for it, depending on a variety of market factors, including prevailing interest rates. Additionally, in the case of a bond that is subject to redemption — or “callable” — yield may be reduced when a state or local government redeems a bond before maturity because the investor will not receive the full payment of interest expected over the life of the bond.

#### **4. Is the Bond Callable?**

A bond is “callable” when a state or local government has the option to redeem a bond before the stated maturity date and at a specific price. Bonds are most commonly “called” because the bond is paying a higher interest rate than current market rates. Under such conditions, state and local governments may find it advantageous to retire a bond and issue bonds paying a reduced interest rate in a process known as refunding.

When a bond is called, investors in the bond generally receive only the principal and interest accrued up to the redemption date and will not receive the full interest due over the stated term of the bond. This is an important consideration for investors who plan to rely on the interest generated over the full life of a bond. If prevailing interest rates are lower when a bond is called, investors will find it difficult to replace the bond with an equivalent investment paying a similar interest rate

to the called bond. Investors can learn whether a bond is callable and the terms under which it may be redeemed by reviewing a bond’s official statement on the EMMA website.

#### **5. Is the Investment Appropriate for My Tax Status?**

Tax considerations are especially important for municipal bond investors. Many municipal bonds are tax-exempt; however, some, such as Build America Bonds, are taxable. Investors should discuss with their broker the difference between taxable and tax-exempt municipal bonds and the advantages and disadvantages of each for their investment strategy. The tax treatment of tax-exempt bonds may vary depending on where an investor lives.

A bond may be exempt from federal income taxes but not from state and local income or other taxes. Some states exempt from taxes only their own municipal bonds, while others also exempt those of other states. Investors should discuss with their broker how the bond they plan to buy would be taxed in their state. Additionally, investors should discuss with their financial professional the implications of their individual tax bracket on the suitability of an investment. In general, the higher an individual’s tax bracket, the greater the after-tax yield of a tax-exempt bond.

Also, tax-exempt bonds may not be an efficient investment for certain tax-advantaged accounts, such as an IRA or 401k, as the tax-advantages of such accounts render the tax-exempt features of municipal bonds redundant. Furthermore, since withdrawals from most of those accounts are subject to tax, placing a tax-exempt bond in such an account has the



[Subscribe to investor education and EMMA email updates from the MSRB.](#)

effect of converting tax-exempt income into taxable income. Finally, if an investor purchases bonds in the secondary market at a discount, part of the gain received upon sale may be subject to regular income tax rates rather than capital gains rates.

## 6. Is the Price I Am Being Offered Fair?

Brokers, dealers and banks selling municipal securities are subject to the MSRB's fair pricing rules when they trade with investors. Investors should not hesitate to ask their financial professional about the pricing of their trades. Additionally, real-time trade information on the EMMA website allows investors to find both recent and historical prices for a bond, which can help investors evaluate whether they are being offered a fair price.

## 7. How Is My Broker Compensated?

Investors should understand how their broker is compensated and should feel free to ask about any fees, charges or other basis for compensation. It is unusual for a broker to charge a commission for trading a municipal security. Instead, when an investor purchases a municipal security through a broker, he or she typically will pay a "mark-up," included in the price of the bond. Similarly, when an investor sells a municipal bond, he or she typically will pay

a "mark-down," included in the price of the bond. The amount of a "mark-up" or "mark-down" is the difference between the price to the investor and the "prevailing market price" of the bond — the prevailing price at which brokers purchase and sell a bond among one another at a given time. Typically, when an investor buys a bond, the prevailing market price for that bond will be the price the broker paid for it in a close-in-time transaction. Likewise, when an investor sells a bond, typically the prevailing market price will be the price the broker received for it in a close-in-time transaction.

MSRB rules require mark-ups and mark-downs on certain transactions to be disclosed on an investor's trade confirmation. If you have any questions about the disclosed mark-up or mark-down, or you don't see a disclosure, and are interested in learning how much your broker was compensated on your transaction, reach out to your broker.

[EMMA trade price graphs](#) can help you see what others have paid for the same bond. View the summary graph for the daily high and low price for your bond, or access the details view to see each individual trade.

In some cases, instead of relying on transaction-based markups or markdowns, brokers may charge their customers an account-based fee that compensates the professional based on the amount of an investor's assets under management.



Subscribe to investor education and EMMA email updates from the MSRB.