



Taxable Municipal Bonds: The Most Overlooked Bonds in the Fixed Income Market

APA has come to view taxable municipals as a viable alternative to corporate bonds, even though corporate bonds are often thought of as the de facto credit sector investment. To institutional bond investors, we pose the question, why not use taxable municipals in addition to corporates and other taxable bonds to capitalize on the attractive risk/return tradeoff and diversification opportunity of investing in taxable municipals? APA believes the market opportunity to capitalize on this value has emerged thanks to the muni market having developed the size, issuance, and liquidity necessary for institutional accounts. Investors seeking to take advantage of this opportunity should keep several key points in mind.

**Exhibit 1:
Spreads (basis points) to comparable United States Treasuries, as of 9/13/17**

Benchmark	2 YR	3 YR	5 YR	10 YR	30 YR
AA Corporate	32	39	47	80	107
AA Taxable Municipal	43	46	53	66	83
A Corporate	47	56	64	95	114
A Taxable Municipal	78	83	93	111	121
BBB Corporate	75	87	101	144	156
BBB Taxable Municipal	159	164	178	206	238

APA believes that ample opportunity exists outside of the most common taxable municipal names, but building a diversified portfolio of taxable municipals requires the ability to source bonds and use dynamic portfolio management and monitoring practices. We also believe taxable municipal bonds offer value as high-quality, comparable yielding substitutes for corporate bonds. While some investors understand this concept, our opinion is that the market as a whole does not fully recognize the value proposition. For this reason, we continue to see taxable municipals as an attractive option for long credit investors.

Source: Bloomberg, LP. BVAL Pricing Benchmarks: AA+,AA,AA-. A+,A,A-. BBB+,BBB,BBB-
Note: With the Corporate bond market now down to only two (2) AAA issuers, palling in comparison to the wide AAA market for municipal issuers, we have removed the benchmark for this comparison.

A Long History of Managing Taxable Municipal Portfolios

APA has been a portfolio manager of taxable municipal bonds since the mid-90s and we continue to recommend this subset of the municipal bond market to the client that cannot benefit from tax exempt bonds. Yields on taxable municipals are typically comparable to those of other taxable issues such as US government agencies, corporate bonds but they provide a better risk/reward profile as shown in Exhibit 3. The basic value for taxable municipals is generally understood to be attractive yields and historically low default risk. APA has the experience and expertise to build for your clients a competitive yielding and diversified taxable municipal portfolio using our network of dealers who specialize in this sector of the municipal bond market. Sourcing taxable municipals for both attractive structures and yields can be challenging. We buy and sell with over 100 dealers and market makers.

Why would a municipality issue bonds that are subject to federal taxes?

Taxable municipal bonds are generally issued to finance a project or activity that does not provide a significant benefit to the general public. In such cases, the federal government will not permit the federal tax-exemption that is a prominent feature of most municipal bonds. It may, however, offer state and local tax exemption on interest paid to investors who reside in the state of issuance. This is particularly appealing to investors in high tax states such as California, New Jersey, and New York. Finally, the Tax Reform Act of 1986 created several restrictions one of which was to eliminate the tax exemption on private-activity bonds where a municipality issues bonds to fund private projects. The 1986 Tax Act was basically the genesis of taxable municipals. Before the passage there were many abuses of tax exemption. In 1984 only 25% of the issuance that year was for public purpose.¹ Between 1970 and 1986, no individual year witnessed more than \$830 million of issuance. In the decade following the Reform Act, however, an average of \$6.3 billion of taxable municipal bonds was issued annually. ² Meanwhile, 2009 and 2010 were banner years for issuance, as shown in Exhibit 2. From 2011 to the present has also witnessed fairly solid supply, with over \$30 billion of average annual new issuance. Much of this issuance has come from issuers taking advantage of low rates to advance refund older tax-exempt bonds using taxable municipal bonds.

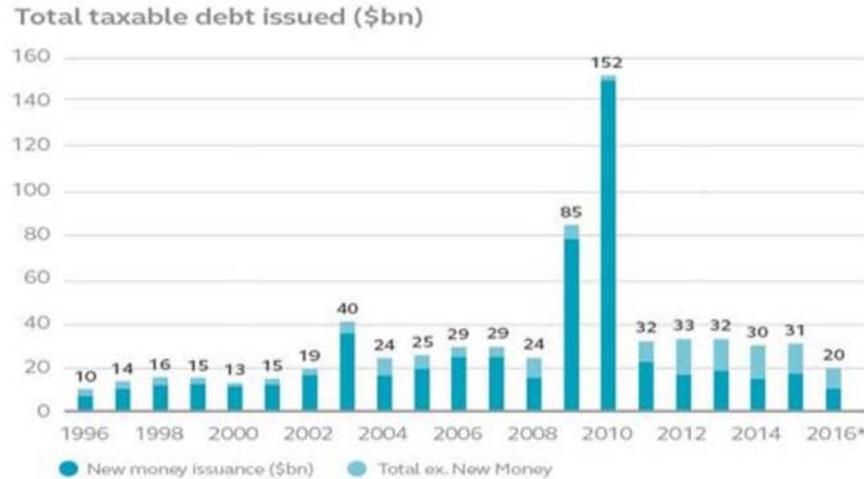


Trading Volume is Similar to Corporates

Prior to 2009, the taxable municipal market was more of a “one-off” market with limited product, few active dealers, and marginal participation from institutional investors. The BABs (Build America Bonds) program sparked a dramatic change in the market by bringing in a new group of institutional investors and encouraging dealers to increase their presence in the taxable muni market. Today, the taxable muni market has some of the liquidity characteristics of an institutional bond market. One

Exhibit 2: Taxable U.S. Municipal Issuance is Stable

Source: J.P. Morgan



Note: includes non-pre-refunded debt, fixed and zero coupon, with maturities 1 year or greater. *2016 year to date through August 2016.

Low Defaults

As mentioned above a major benefit of U.S. municipal bonds lies in the low probability of default. As shown in Exhibit 3, the average default rate in 2015 was notably lower within U.S. municipal bonds than fixed income corporates at all credit qualities.

Exhibit 3: Default Rates of U.S. Municipal Bonds vs. U.S. Fixed Income Corporates

Rating	U.S. Municipal Bonds	U.S. Fixed Income Corporates
AAA	0.00	1.21
AA	0.07	1.55
A	0.18	2.95
BBB	0.69	6.60
BB	5.02	18.75
B	12.73	31.19
CCC/C	41.15	58.54
Investment grade	0.25	3.89
Speculative grade	9.62	27.70

^{1,2}Bloomberg MSRC search for federally taxable bonds issued 1/1/1970—4/30/2015, accessed July 26, 2017

³Bloomberg MSRC search for trading volume of taxable munis vs corporates, accessed August 28, 2017.

For more information about APA's customized portfolio management, please contact:

ContactUs@AssetPreservationAdvisors.com
(404) 261-1333

Source: S&P Global Market Intelligence, a division of S&P Global Inc. Data as of 6 May 2016.

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