Maintaining the Municipal Advantage

Analyzing municipals amidst tax policy uncertainty

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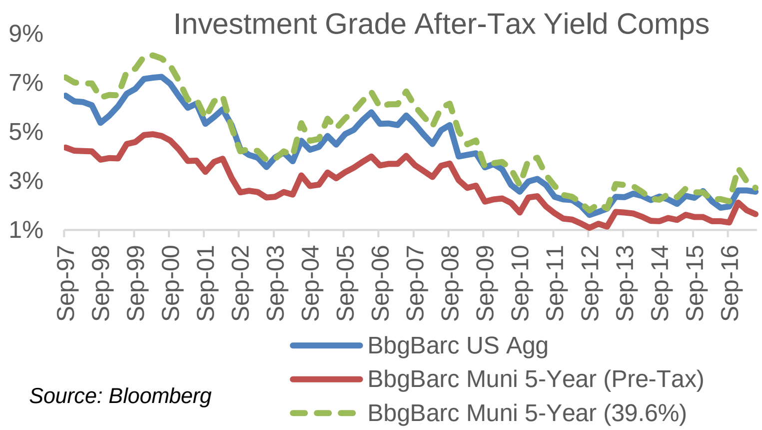
Following the 2016 presidential election, the inclusion of municipal bonds in a taxable portfolio's strategic asset allocation began to be questioned due to concerns about the future tax treatment of the asset class. That concern resulted in significant outflows and price pressure within the municipal market. More recently, the Trump administration put forth its preliminary tax plan that hopes to lower corporate income taxes as well as personal income taxes, among other objectives. The preliminary plan calls for a reduction in the top marginal tax rate from the current 39.6%, excluding state income taxes, to 35% or roughly a 12% reduction in personal income taxes.



Source: Bloomberg

Lowering income tax rates raises a crucial question: at what point do the tax-exempt benefits of municipal bonds no longer exist? Over the last 20 years, beginning in September 1997, on a pre-tax basis the Bloomberg Barclays US Agg Bond Index maintains an average spread advantage of 1.35% relative to the Bloomberg Barclays 5-Year Municipal Bond Index. However, it's not just what you earn, but what you keep. When we consider the taxes paid on nominal bonds, an allocation to municipal bonds is attractive on an after tax-basis.

While yields rarely move in tandem we identified the breakeven tax-rate at which the tax-equivalent yield advantage no longer persists, assuming the highest marginal tax rate and excluding additional taxes such as state income tax and AMT, over various time periods. When comparing the Bloomberg Barclays Aggregate to the Bloomberg Barclays 5-Year Municipal Bond Index, we found over various historical periods the breakeven point was between a 31% and 33% tax-rate, on the low end that implies roughly a 22% reduction in income tax rates.

	Avg BbgBarc US Agg Bond Yield	Avg BbgBarc Muni 5-Year Yield	Avg Breakeven Tax Rate
5-Year	2.28%	1.53%	33.19%
10-Year	2.82%	1.93%	31.83%
15-Year	3.45%	2.34%	32.20%
20-year	4.12%	2.77%	32.72%

Source: Bloomberg

We are not in the business of forecasting political outcomes, nor do we believe that investors should modify their portfolios based on uncertain outcomes in Washington. That being said, the likelihood of new legislation passing that is more accommodative to taxpayers beyond what has been proposed seems remote.

This only enhances our opinion that investors will likely continue to benefit from municipal bonds. Outside of after-tax return, there remains a multitude of reasons to own the asset class such as its diversification characteristics, the relatively low efficiency of the market providing investors opportunity and its status as a safe haven asset. We continue to believe municipal bonds can play an important role in portfolios in spite of headline risk or even the realization of lower tax rates.

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Ryan researches and performs operational due diligence on core investment managers. He is a team member of our Core Investment Strategy Group. Prior to joining the firm in 2014, Ryan served as a Research Assistant in U.S. Public Finance for S&P Ratings Services. He received a BS in Management from Indiana University's School of Public and Environmental Affairs. He is a CFA® charterholder and member of the CFA Society of Chicago and CFA Institute. Ryan is a member of the Children's Research Fund Junior Board and enjoys competing in triathlons.