Use muni bonds to build your high-net-worth business

Higher rates bring great opportunity for financial advisors focused on adding value to clients of exceptional wealth

Dave Rudd
President

Dave Rudd is a 20-year veteran of institutional fixed income sales and trading, and one of the visionaries behind BondNav, InspereX's fixed income technology. Driven by a belief that dealers should compete for advisors' business, and that technology should play an integral part of that process, he set out to develop a conflict-free model centered around best execution. Previously, Mr. Rudd was Director of Fixed Income Capital Markets and a top producer at RW Baird in San Francisco. His earlier roles include Institutional Sales at RBC Capital Markets, Piper Jaffray, and Fidelity Capital Markets. He is a native of Silicon Valley and a graduate of the University of Arizona with a degree in economics.

How munis fit into the fixed income conversation

Financial advisors seeking to build their high-net-worth business should be taking a fresh look at municipal bonds and the potential opportunities for their clients to benefit from the changing interest rate environment.

Unfortunately, the rising rate environment is leaving investors with few hiding places, resulting in advisors having difficult conversations with their clients. Inflation and the prospect of higher rates remain concerning.

That's the bad news. The good news is that the current market also creates an opportunity for financial advisors to demonstrate value to high-net-worth investors by showcasing how municipal bonds may help them achieve their income goals in ways that are distinctly different than municipal bond funds or exchange traded funds.

It is important to note that municipal bonds have single security market and credit risk. However, given that they have a fixed maturity date, their interest rate duration risk will slowly decline over time as the maturity date grows closer. This is an important feature to consider, especially with the risk of rising interest rates.

It is also important to educate your clients about the impact the purchase price will have on the return at maturity, and that muni bonds may be called, which would result in return of principal, and they may not be able to invest at the same or better rate.

The potential for tax benefits

One of the most noted features about municipal bonds is the potential for tax-free income. Investors in the highest tax brackets who own Federal and State tax-free municipal bonds in the 3-4% yield range (as illustrated in the table below[1]) would have to earn between 4.5% and almost 6% in taxable income to match that tax-free income – and they would have to consider the potential of taking on more risk to get there.

In addition, municipal bonds are considered historically low-risk fixed income investments – between 1970 and 2020, "the default rates for investment-grade municipal bonds were 0.10% compared to 2.24% for investment-grade corporate bonds."[1]

Tax-exempt yield	Investor tax bracket						
	10%	**15%**	**25%**	**28%**	**33%**	**35%**	**39.60%**
	Taxable-equivalent yield						
1%	1.11%	1.18%	1.33%	1.39%	1.49%	1.54%	1.66%
2%	2.22%	2.35%	2.67%	2.78%	2.99%	3.08%	3.31%
3%	3.33%	3.53%	4.00%	4.17%	4.48%	4.62%	4.97%
4%	4.44%	4.71%	5.33%	5.56%	5.97%	6.15%	6.62%
5%	5.56%	5.88%	6.67%	6.94%	7.46%	7.69%	8.28%

[1] https://www.msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf

3 Muni strategies to grow your high-net-worth business

Rising rates have created three potential opportunities for financial advisors to add significant value to high-net-worth investors through the use of municipal bonds.

1 Bond ladders add certainty to existing fixed income portfolios

Investors facing fixed income investments that are losing value may be wondering: if they have very specific income needs and are afraid of further losses, should they sell instead of holding to maturity? Advisors serving high-net-worth, long-term, buy-and-hold investors may be suggesting that investors sit tight for now and keep taking the income from their bond funds and ETFs.

But it may be an ideal time for advisors to recommend that high-net-worth investors bolster their fixed income strategy with individual municipal bonds to add a component that may be lacking: some payment certainty in their fixed income portfolio. Knowing exactly what they own and precisely how it will deliver income and return principal at maturity[2] may be the formula for peace of mind during turbulent times.

A customized, laddered portfolio of municipal bonds provides advantages in a rising rate environment, as the bonds coming due can be replaced with bonds that may capture potentially higher yields, assuming the yield curve is not inverted or flat.

A ladder may also open the door for achieving investment goals that address their personal values – all of which can certainly demonstrate your added value.

[2] Subject ot the credit risk of the issuer

2 Cash management with higher tax-free rates

Depending on what your clients' investment objective is for their cash management strategy, they might appreciate the ability to hedge interest rate risk while receiving potentially higher tax-free yield offered by two municipal investments: the floating-rate municipal bond, and the pre-refunding municipal bond.

Floating Rate Munis

Unlike other municipal bonds with fixed returns, floating-rate municipal bonds do exactly as they say – they float, or adjust, at predetermined periods to reflect changes in market rates. For investors who believe interest rates will continue to rise, floating-rate munis may provide access to higher levels of income that are often exempt from Federal and possibly State taxes. Floating rate bonds typically have a lower duration due to the variable nature of the coupon.

Pre-Refunding Munis

Pre-refunding municipal bonds are issued by municipalities to refinance outstanding bonds to take advantage of interest rate savings or to restructure a debt profile. These pre-refunding bonds are issued in advance of the outstanding bonds' call date, and the proceeds are held in escrow and most frequently invested in U.S. Treasuries backed by the full faith and credit of the United States. The income from pre-refunding bonds is exempt from Federal and State income tax, depending on residency.

With the certainty of U.S. Treasuries securing the bond payments, shorter duration, plus the added benefit of tax-free income, pre-refunding municipal bonds may also provide the potential to deliver higher income than cash accounts.

They could be the ideal cash management solution for high-net-worth investors seeking the potential for higher yield.

3 Address their legacy concerns and increase their income

Protecting their legacy for generations to come is a common objective among individuals of exceptional wealth. They want to assure that their capital is protected, but they may also be living on a fixed income and want their capital to generate returns sufficient to fund their quality of life.

Federally tax-free municipal bonds check all the boxes: they provide 100% return of principal at maturity;[2] and they are fully transparent with clearly defined interest rates and frequency of payments. There is a possibility that a bond may be "called" at the issuer's discretion and at any time prior to the maturity date. If the bond is called, the investor may not be able to reinvest in a municipal bond with similar or favorable terms.

The tax-exempt nature of munis may generate yields equivalent to higher-risk taxable bonds without complicating tax returns. Additionally, investors have the ability to invest in bonds with proceeds that are directly aligned with their purpose objectives.

Plus, as a result of today's rising interest rates, many new issue longer-term municipal bonds are generating higher yields at more attractive prices than in recent years – giving long-term buy-and-hold affluent investors the opportunity to lock in higher levels of tax-exempt income to fund their lifestyle with the return of their principal at maturity.[2]

Thanks to the size, scope and activity of the municipal bond market, heirs who inherit municipal bond assets will find a largely liquid market should they wish to sell.

To help deliver exceptional value to legacy-minded investors of significant wealth, advisors have the opportunity to create portfolios of long-term, high quality municipal bonds to manage rising interest rate risk.

[2] Subject ot the credit risk of the issuer

Transparency is the key to adding value

For investors to enjoy the most effective experience with municipal bonds, it's critical advisors provide clear guidance to help clients achieve their investment objectives. This is where advisors are able to add significant value. Assisting clients with a more customized approach to their fixed income strategies and managing interest rate duration risk may be more transparent when selecting individual municipal bonds versus municipal bond ETFs that, depending on the offering, may have the potential to expose investors to more interest rate risk, as well as triggering Alternative Minimum Tax thresholds and/or taxation of out of state bond interest.

Approximately
$4 trillion
municipal bond market[1]

Approximately
50,000
different issuers

More than
1.4 million
unique maturities

The roughly $4 trillion municipal bond market has approximately 50,000 different largely recognizable issuers[1] with more than 1.4 million unique maturities.[3] To navigate this landscape, financial advisors need to have the tools and information to identify the right bonds for their high-net-worth clients among both new issues and the broad secondary municipal market.

New bond inventory from large infrastructure projects stimulated by the American Rescue Plan Act (ARPA) are expected to come to market and will lead to the improvement of roads and bridges, water and sewer systems, schools, airports, and much more – in cities, counties, and states across the U.S. These projects give investors an opportunity to see and experience the impact of their investments firsthand, potentially satisfying certain purpose-based investment objectives while adding predetermined payouts and return of principal at maturity[2] and the possibility of significant tax advantages.[4]

[1] https://www.msrb.org/msrb1/pdfs/MSRB-Muni-Facts.pdf

[2] Subject to the credit risk of the issuer

[3] CUSIP Global Services, April 28, 2022

[4] With tax-exempt municipal bonds, investors can receive federal, state and local tax-free interest payments. State and local tax exemptions may apply to residents of the same state where the bond is issued. You should read the applicable tax risk disclosures in the offering document when considering the purchase of municipal bonds.

What you should know before investing in municipal bonds

Speak with your financial professional and tax advisor about the risks and suitability of municipal bonds in your portfolio.

Call risk
Some munis have call provisions, which means they can be redeemed, or paid off, at the issuer's discretion, or subject to the terms of the muni, prior to maturity. Often, an issuer will call munis when interest rates fall, potentially leaving investors unable to reinvest with similar or better terms.

Credit risk
Munis are subject to the credit risk of the issuer. If the issuer defaults on its obligations, some or all of your payments, including coupons and principal, could be at risk. Additionally, changes to an issuer's credit will generally affect the secondary market value of munis.

Interest rate risk
When interest rates rise, bond prices fall; when interest rates decline, bond prices rise. Changes in interest rates may reduce or increase the market value of munis. The longer the maturity of munis, the greater the impact changing interest rates can have on their price.

Liquidity risk
While many broker-dealers maintain an active secondary market to resell munis at prevailing market rates, there is no assurance that a secondary market will be maintained. If you sell munis prior to maturity, you may receive more or less than your original investment depending on market conditions.

Tax implications
Tax consequences of municipal bonds may depend on the particular terms of the offering. Before purchasing a muni, please consult with your tax advisor. You should also read the applicable tax risk disclosures in the offering document when considering the purchase of a muni. Income from municipal bonds may be subject to the Alternative Minimum Tax (AMT).

InspereX℠

insperex.com℠

InspereX LLC and its affiliates explicitly disclaim any responsibility for product suitability or suitability determinations related to individual investors. This information should not be regarded by recipients as a substitute for the exercise of their own independent judgment, and the information provided herein is not an offer, solicitation, or a recommendation to buy, sell, or hold any security or investment strategy. There can be no assurance that the investments shown herein were or will be profitable, and this material does not take into account any investor's investment objectives, financial situation, particular needs, strategies, tax status, or time horizon.

Any financial product sold prior to maturity may be worth more or less than the original amount invested. Depending upon the specific product offering, investment risks include, but are not limited to, market risk, interest rate risk, credit risk, call risk, reinvestment risk and liquidity risk. Additionally, the products discussed herein are not FDIC insured, may lose value, and are not bank guaranteed. Investors should refer to the offering documents for applicable risk considerations.

BondNav is a technology platform that is not registered with the U.S. Securities and Exchange Commission as a broker-dealer or member of the Financial Industry Regulatory Authority. Thus, securities listed on BondNav can only be bought or sold through Insperex LLC, a registered broker-dealer, or another registered broker-dealer.

The information contained herein does not constitute an offer to sell or a solicitation of an offer to buy securities. Investment products described herein may not be offered for sale in any state or jurisdiction in which such an offer, solicitation, or sale would be unlawful or prohibited by the specific offering documentation.

MUNI-WP-0123