# Should an Investor Still Invest in Muni Bonds?

Municipal bonds (munis) have been under pressure since the Presidential election a few months ago as investors were quick to sell these bonds amid the rising chorus of potential tax-cuts. At Lynx, we believe that muni bonds are likely to face headwinds, which we outline below, but ultimately we feel that those investors that continue to hold municipal bonds will be rewarded. Just like every other investment, it comes down to valuation.

In the collective opinion of commentators, municipal bonds face the following few significant challenges, all stemming from the new administration's policies or promises:

a) Tax rate: While there is zero evidence that the income generated from muni bonds will lose its tax exemption, there is a strong possibility that personal taxes will be lowered, reducing the allure of muni bonds. For an investor, there is always a choice between various kinds of bonds. A rational investor makes this choice primarily based on tax equivalent yields offered by munis, taking in to account similar duration and credit risk. Today, many believe that munis will be less attractive on this basis.

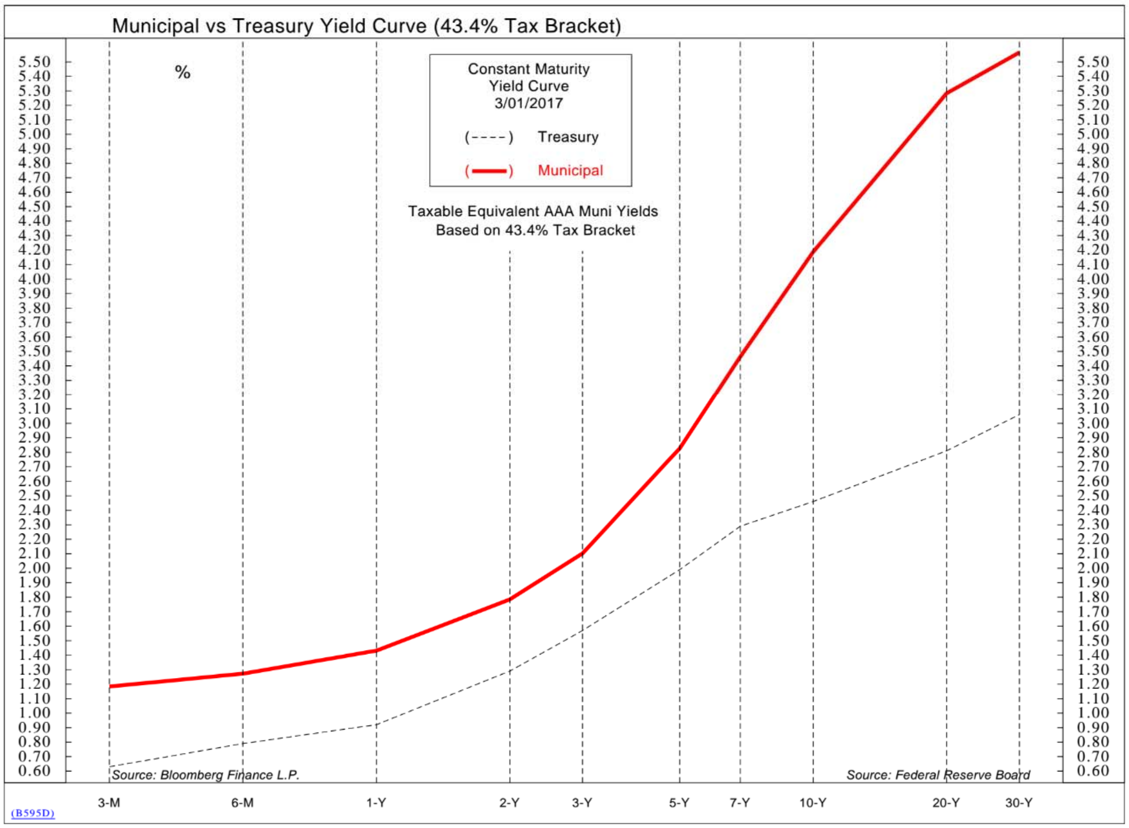
b) Repeal of Obamacare: Many community hospitals have benefited from the expansion of Medicaid provided by Federal aid through Obamacare. Therefore, any change that leaves states responsible for funding more of Medicaid or changes in eligibility to qualify for Medicaid will have an adverse impact on muni bonds issued to fund such projects.

c) Demand from banks and insurance companies: It has been estimated that approximately one third of the demand for munis continues to originate from non-traditional buyers such as banks and insurance companies that find their tax equivalent yield attractive. Any change in munis' relative attractiveness vis-à-vis corporates makes them less desirable.

While all the above challenges are true and we agree that munis face headwinds, we believe an investor will be rewarded for holding them given today's valuations. This is especially true for bonds backed by strong credit research. There are many ways to look at valuations within the asset class, but for our analysis we will review two approaches. We will begin by commenting on the tax equivalent yield of munis versus treasuries, following which we will discuss the relative attractiveness of corporate bonds versus muni bonds.

For an investor that is in the marginal income tax bracket of 43.4%, the tax equivalent yield for a AAA rated muni credit for a 10-year bond is approximately 4.2%, while the equivalent treasury bonds trades at 2.6% (figure 1). This difference of 1.6% between a treasury and muni bond, is, in our opinion, attractive enough for an investor to hold munis over treasuries.

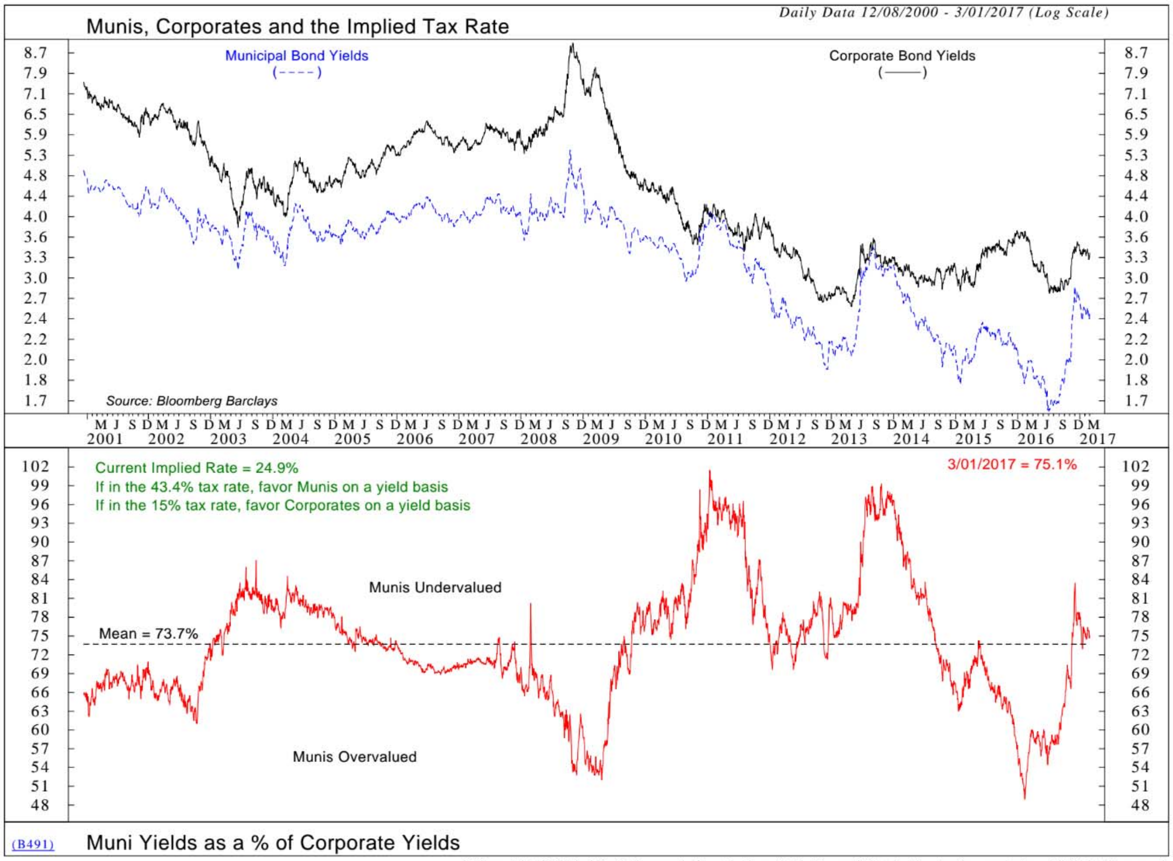
Figure 1





Now, let's look at the relative attractiveness of munis versus corporate bonds by examining figure-2. The top chart simply displays muni and corporate bonds yields. The bottom chart depicts the implied tax rate that would equate a portfolio of corporate to muni bonds for an investor. Looking at the two yield curves and the muni-corporate ratio (muni yield as % of corp yield), the current implied tax rate is 24.9%.

Figure 2





In other words, the above chart implies that if an investor is in any income tax bracket below 25%, they should favor corporates but for an investor that is in a tax bracket above 25%, munis are a better investment.

In summary, while we agree that there are short-term headwinds facing the muni market, we believe that the muni yields when compared with treasuries and corporates remain attractive, especially for an investor in the top tax bracket. In addition, an investor may save on local state taxes by buying local state munis. At Lynx, we favor a low cost separate account approach to investing in muni bonds, which allows an investor to tailor the bonds based on risk, sector and geography, as well as ensures that the investments are not exposed to mutual fund trading and liquidity flows.

Date: March 2017