Investor Alerts and Bulletins

Investor Bulletin: Municipal Bonds – Asset Allocation, Diversification, and Risk

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The SEC's Offices of Investor Education and Advocacy and Municipal Securities are issuing a series of three Investor Bulletins to help educate investors about the municipal securities market. This Bulletin provides a general overview on asset allocation and diversification in an investment portfolio, with a focus on the role of municipal bonds.

Asset Allocation and Diversification Generally

Asset allocation and diversification are investment techniques that can help investors reduce risk and volatility in their portfolio. Asset allocation involves dividing your investment portfolio among different asset categories, such as stocks, bonds, and cash. One common approach is to allocate 50% of your portfolio to stocks, 40% to bonds, and 10% to cash. Diversification involves spreading your investments among different investment products, including within each of your portfolio's asset categories. For example, within the bond category, you may decide to hold different bonds with differing characteristics, such as in U.S. corporate bonds, U.S. government bonds, or municipal bonds.

The asset allocation and diversification that works best for you at any given point in your life will depend largely on your time horizon (that is, how long until you expect to want to sell the investment) and your ability to tolerate risk (that is, the degree of uncertainty and/or potential financial loss inherent in an investment decision). For additional information on asset allocation and diversification, please read our "Beginners' Guide to Asset Allocation, Diversification, and Rebalancing."

The Role of Municipal Bonds in a Portfolio

Some investors choose to invest in bonds as part of their overall portfolio.

Municipal bonds are one specific type of bond investors might consider. Municipal bonds are debt securities issued by states, cities, towns, counties, U.S. territories (e.g., U.S. Virgin Islands, Guam, and Puerto Rico), and other governmental entities to finance capital projects such as building schools, highways or sewer systems and to fund day-to-day government needs as well.

Generally, the interest investors receive on municipal bonds is exempt from federal income tax. The interest may also be exempt from state and local taxes if you reside in the state where the bond is issued or if the bond is issued by a U.S. territory. Given the tax benefits, the interest rate for municipal bonds is usually lower than on taxable fixed-income securities such as corporate bonds with similar maturities, credit qualities and other terms. For additional information about the characteristics of municipal bonds, please read our Investor Bulletin: Municipal Bonds – An Overview.

Understanding Risk

Investors interested in including municipal bonds in their portfolio should understand that all investments, including bonds, have risk. Just as equity investments (such as stock) involve different levels of risk, the same is true of bonds. Investments in some bonds may involve more risk than equity investments. While municipal bonds generally may involve less risk than other bonds, the characteristics and related risks of municipal bonds vary widely. For additional information about the diversity of municipal issuers, please read our Investor Bulletin: The Municipal Securities Market. **Diversifying your municipal bond investments may help reduce the risk associated with these investments.**

Investors should take the time to research the particular municipal bond issuer they are considering, and understand the risks involved. Some of those risks include:

- **Credit or Default risk.** This is the risk that the municipal bond issuer may experience financial problems that make it difficult or impossible to pay interest and principal in full, so that the issuer "defaults" on its ability to pay investors. Municipal bond defaults are generally rare. However, a handful of municipal issuers have defaulted on their municipal bonds. For example, in July 2013, the city of Detroit, Michigan filed for bankruptcy related to approximately $18-20 billion dollars of debt. In 2017, a federal oversight board commenced a bankruptcy-like process for the U.S. territory of Puerto Rico related to approximately $70 billion dollars of debt. Some factors which may impact a municipal issuer's credit risk include:
  - Adverse political, legislative or regulatory developments;
  - Fluctuating local economic conditions that reduce tax revenues, increase expenses for social insurance programs, and strain issuer's budgets; and
  - Increased financial pressure related to funding public pension plans.

  For additional information on how credit risk may impact a municipal bond investment, please read our Investor Bulletin: Municipal Bonds – Understanding Credit Risk. This bulletin also discusses credit ratings and factors investors should consider when using these ratings to evaluate municipal bond investments.
- **Call risk.** Call risk refers to the potential for a municipal bond issuer to retire a bond before its maturity date, something that an issuer may do if interest rates decline – much as a homeowner might refinance a mortgage loan to benefit from lower interest rates. A callable municipal bond allows the issuer to redeem some or all of the outstanding municipal bonds on or after a specified "call date" before the specified maturity date. The price the municipality pays for called municipal bonds is predetermined and might differ from the bond's market price when it's called. Investors who purchased the bond on the secondary market may receive more or less than they paid for the bond. Bond calls are less likely when interest rates are stable or moving higher. Many municipal bonds are "callable," so investors who want to hold a municipal bond to maturity should research the bond's call provisions before making a purchase. Investors wishing to research municipal bonds may access disclosure documents and real-time price data online free of charge at the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) website.
- **Inflation risk.** Inflation is a general upward movement in prices. Inflation reduces purchasing power, which is a risk for investors receiving a fixed rate of interest. It also can lead to higher interest rates and lower bond prices.
- **Interest rate risk.** Bonds have a fixed face value, known as the "par" value. If bonds are held to maturity, the investor will receive the face value amount back, plus interest that may be set at a fixed or variable rate. The bond's price will move up as interest rates move down and it will decline as interest rates rise, so that the market value of the bond may be more or less than the par value. If interest rates move higher, investors who hold a fixed-rate municipal bond and try to sell it before it matures could lose money. Rising interest rates will make newly issued bonds more appealing to investors because the newer bonds will pay a higher rate of interest than the older ones. For additional information on how interest rate risk may impact

a municipal bond investment, please read our Investor Bulletin: Fixed Income Investment – When Interest Rates Go Up, Prices of Fixed-Rate Bonds Fall.

- **Liquidity risk**. This refers to the risk that investors will not find an active market for the municipal bond, potentially preventing them from buying or selling when they want and making pricing more difficult. Many investors buy municipal bonds to hold them rather than to trade them, so the market for a particular bond may not be especially liquid and quoted prices for the same bond may differ. Investors can access real-time price data at no charge and see how their municipal bonds or similar bonds have traded recently at the Municipal Securities Rulemaking Board's EMMA website at www.emma.msrb.org. Recent price information may not be available for bonds that do not trade frequently.

Related Information

Investor Bulletin: Municipal Bonds – An Overview

Investor Bulletin: The Municipal Securities Market

FINRA and MSRB Investor Alert: Municipal Bonds – Staying on the Safe Side of the Street in Rough Times (available at http://www.finra.org/investors/protectyourself/investoralerts/bonds/p118923)

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