MUNICIPAL BONDS

ADVISORS ASSET MANAGEMENT

Fixed income market insights from Advisors Asset Management, Inc.

Municipal bonds are debt instruments issued by state, county, or local governments and their associated agencies to raise capital for operations or special development projects. A key feature of most municipal bonds, or "munis", is their interest payments are generally exempt from federal, state, and local taxes. Thus, the issuing municipality benefits from the ability to raise capital at lower rates and investors potentially benefit from the tax break received on interest income.

Municipal bond issuers may be state, city or county-level governments or particular entities within these localities such as school districts, public utilities and redevelopment agencies, among others. At issuance, maturities for municipal bonds generally span over many years, and can extend to 30 or 40 years.

Main Types of Municipal Bonds

Municipal bonds fall into two broad categories: general obligation bonds and revenue bonds.

- **General Obligation (GO) Bonds**
  General obligation bonds are backed by the general tax revenue of the issuing municipality. Municipal governments are usually permitted by the bond indenture to tax residential and commercial property to support interest and principal payments. Since this usually represents a secure form of revenue that can potentially be increased if required, general obligation bonds are usually considered safe investments.

  Some general obligation bonds are backed by a "limited-tax" pledge which permits municipalities to raise tax revenue to support the bond payments up to a statutory limit. If the municipality finds itself unable to meet its bond obligations without raising property taxes above the limit, the risk of default increases.

  Other general obligation bonds are backed by an "unlimited-tax" pledge which permits municipalities to raise tax rates to whatever level is required to secure bond payments. For this reason, unlimited-tax pledge bonds are considered safer than limited-tax pledge bonds and will be traded at lower yields – assuming comparability of all other features.

- **Revenue Bonds**
  Revenue bonds are backed by specific revenue-generating operations within the issuing entity such as toll roads, toll bridges, airports, hospitals, and water treatment facilities, to name a few examples.

  Revenue streams from these kinds of enterprises have historically been considered less secure than dedicated tax revenue. Therefore, revenue bonds tend to be considered slightly more risky than general obligation bonds, assuming all other factors remain comparable. Nevertheless, revenue bonds are still considered safe obligations.

Reasons to Consider Municipals:

- **Potential Tax Exemption of Interest Income**
- **Safety and Low Default Risk**
- **Diversity of Choices**

Advisors Asset Management, Inc.

Deeply rooted in the fixed income markets since 1979, Advisors Asset Management, Inc. (AAM) has provided financial professionals with comprehensive access to the bond market in conjunction with simple and efficient trading support. Our long-standing relationships and Capital Markets expertise allows establishment and maintenance of an attractive inventory of securities, offering advisors the opportunity to capitalize on pricing, yields, and quality issues.

AAM's seasoned fixed income trading team is comprised of more than 20 professionals, who average over 16 years of industry experience. Our open-architecture offering system provides advisors access to all major ECNs, as well as our own inventory. For almost 40 years, AAM has been a trusted resource for financial advisors and broker/dealers. In addition to the fixed income markets, AAM offers access to structured products, unit investment trusts (UITs), mutual funds, managed accounts, and ETFs.

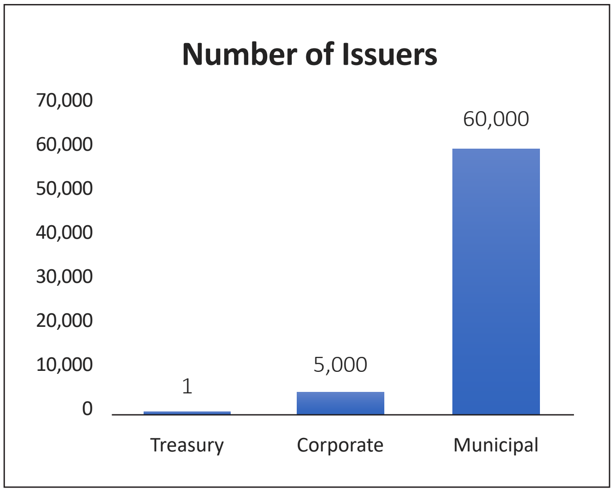
Features and Benefits

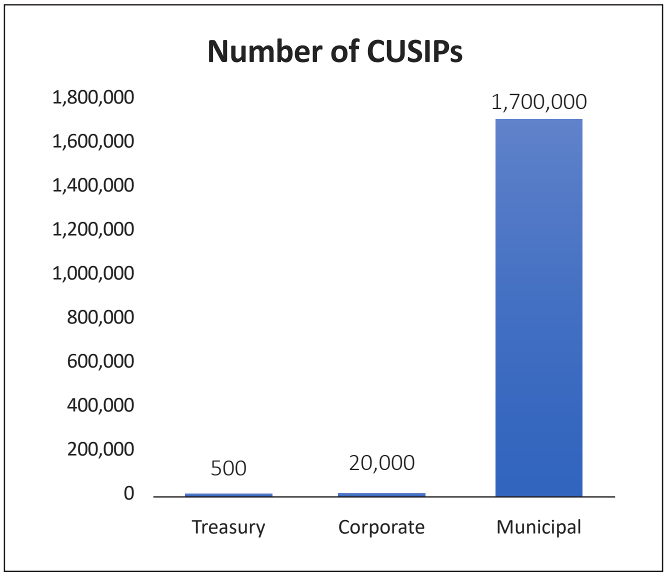
- **Tax Exemption:** As stated, a key feature of most municipal bonds is that interest is exempt from federal, state, and local taxes. This can provide a key benefit to investors, particularly if tax rates at any of these levels are particularly high. Investors must understand, however, that municipal bonds tend to trade at lower yields than taxable alternatives. Investors should always compare the Taxable Equivalent Yield (TEY) of a municipal security with the yields of comparable taxable instruments.

  Investors should also note some municipal bonds will fall outside either the federal, state or local tax exemption rules and may not be exempt from taxes. Most municipal bond offering documents – sometimes called "Official Statements" – will include a legal opinion establishing tax exemptions which may apply.

  Relief from state and local taxes often depends on whether the investor resides in the state from which the municipal bond has been issued. If residents outside the state were to purchase the same municipal securities, they may be taxed at the state and local levels on interest earned. Investors are encouraged to understand the tax implications of their state of residence and its effect upon both in-state and out-of-state interest income.

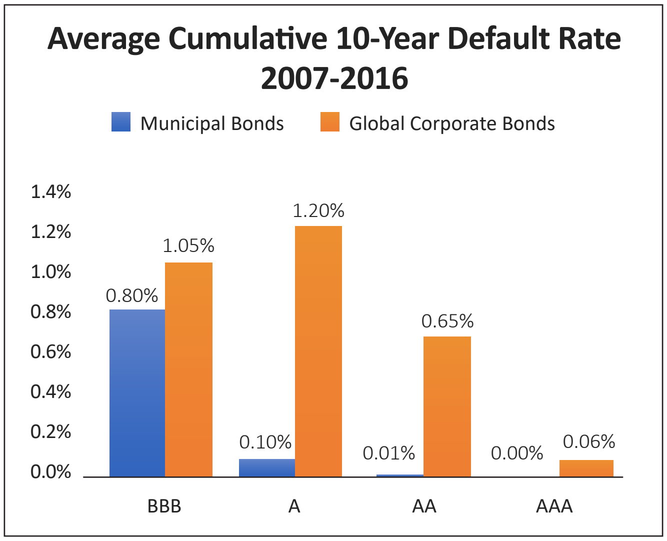
- **Market Complexity:** Despite the fact the outstanding debt for the municipal bond market is approximately 25% of the size of the U.S. Treasury market and 40% of the size of the U.S. Corporate Debt market, its complexity lies in the diversity of choices.





The importance of understanding the nuances of the market, the unique credit characteristics of different issuers, and the performance of the many available different structures from which investors can choose is highlighted by the broad number of credits and available choices for individual securities as indicated by the charts above.

- **Safety:** Municipal bonds are generally considered safe investments. A comparison of the default rates for municipal bonds relative to similarly rated corporate bonds indicates a much lower probability of default.



Source: Moody's Investor Services, Data Report, June 27, 2017

As seen in the table, investors should be aware similar ratings for corporate and municipal securities does not indicate the same level of default risk. The methodologies applied by the rating agencies to these two areas of fixed income securities are different and can result in different attributions for the same level of default risk.

- **Steady Stream of Income and Diversification Benefits:** Traditional municipal bonds can provide investors with a safe, steady stream of tax-free income. Also, since the credit behavior of municipalities can be quite different from that of corporations, municipal bonds can offer measurable asset class diversification to bond portfolios.

Buying and Selling Municipal Bonds

Investors can purchase municipal bonds through a number of different outlets, including bond dealers who specialize in municipal bonds. These specialized dealers offer advantage by their market insights and knowledge about certain bonds and sectors.

Potential Risks

- **Credit and Default Risk:** As with all securities, municipal bonds bear credit or default risk. This is the risk the issuer becomes insolvent and fails to follow through on contractual obligations, causing the investor to lose future interest payments, or worse yet, the original invested principal amount.

  As stated earlier, municipal issuers have a strong track record of not defaulting on their obligations. The tax-backing of GO bonds or the revenue stream of revenue bonds historically has made municipal bonds very safe investments. However, this does not mean they can never default. Investors should understand municipalities can face circumstances which may impair their ability or willingness to repay interest and principal to investors. As examples, in 2013, Detroit became the largest city to file for bankruptcy protection. In 2016, Puerto Rico defaulted on Constitutionally guaranteed GO bonds, which was the first default by a U.S. State or Commonwealth since the Great Depression. Both municipalities shared the common denominator of underfunded pension obligations as a primary catalyst for their credit challenges.

- **Liquidity Risk:** The municipal bond market is relatively small. On average, $10.6 billion in municipal bonds traded daily in 2016. This compares to average daily trading volume of corporate bonds of $30 billion, agency mortgage-backed securities (MBS) of $27 billion and U.S. Treasuries of $514 billion over the same time period.

  It is possible that if an investor is in need of cash and wishes to liquidate municipal bond holdings in the secondary market, he or she may find it difficult to locate buyers willing to purchase those holdings at an acceptable price. This is especially noteworthy during periods of market unrest or volatility.

- **Tax Rate Risk:** While municipal bonds can offer attractive yields and can be a way to generate tax-free income, they may not be right for investors in every tax bracket or for every type of account. For instance, a portion of the income investors receive may be subject to the federal alternative minimum tax (AMT), even if said income is classified as tax free. Also, once a municipal bond is sold, the proceeds from that sale may be subject to capital gains or other types of taxes. With capital gains taxes, earnings are taxed at either the current capital gains tax rate or ordinary income rate, depending on how long bonds were held. Investors may also be taxed on gains characterized as a market discount at their ordinary income rate. Market discount is the difference between the purchase price of a bond and its stated redemption price at maturity.

  It is also important to remember tax laws may change. Favorable tax conditions that existed at the time of purchase of a bond may be either phased out or no longer available to investors. Investors are encouraged to consult a tax advisor before purchasing any security.

- **Interest Rate Risk:** Interest rate risk is the risk general market interest rates will move higher after the purchase of the bond, causing the bond price to decrease. This risk is common to all fixed-income bond investments.

- **Inflation Risk:** Inflation risk is the risk inflation will increase, thereby eroding the real return rate of the municipal bond and possibly turning it negative. This risk is common to all fixed-income investments.

- **Reinvestment and Call Risk:** Reinvestment risk is the risk returned interest or principal payments – whether expected or unexpected – cannot be reinvested into similarly-yielding replacement investments, thereby reducing the overall yield of the investment portfolio.

  Reinvestment risk is particularly exacerbated in the context of call risk. This is the risk that an issuer calls a bond before its contractual maturity, returning principal to the investor earlier than expected. If the investor is unable to purchase a comparable replacement investment, he or she may suffer a reduction of yield in the investment portfolio.

NEXT STEPS

To learn more about municipal bonds, contact your financial professional who can answer questions and provide access to current offerings, as well as assist you in structuring a portfolio that meets your individual investment goals and risk tolerance.

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