Municipal bonds: Three reasons to invest

1. Income

Municipal bonds continue to represent an attractive source of income, despite much-talked-about tax reform and its potential implications. Our view: Lower individual tax rates and/or a potential cap on tax-exemption may lower the value of munis’ tax benefit, but neither change erases it. As shown below, munis still offer an after-tax yield advantage relative to other fixed income assets – even at a lower tax rate.

**Attractive after-tax income, even at lower tax rates**

Yields across fixed income assets

![Graph]

Sources: BlackRock and Bloomberg; as of March 21, 2017. Yields shown are yield to worst. Treasuries represented by the Bloomberg Barclays Treasury Index, munis by the Bloomberg Barclays Municipal Bond Index, aggregate by the Bloomberg Barclays U.S. Aggregate Bond Index and investment-grade by the Bloomberg Barclays U.S. Aggregate Corporate Index. It is not possible to invest directly in an index. TEY (tax equivalent yield) figures show the tax-adjusted yield offered at current top tax rate of 43.4% and assuming a 28% cap on the benefit of tax-exemption.

**Positioning your muni allocation**

While munis may come with more uncertainty and volatility than in recent years prior, that does not make them any less valuable as a core component of a broadly diversified portfolio, in our view. Munis provide the unique advantage of tax-free income (alterable, but not dispensable), high credit quality among fixed income options, and an important ballast to equity and equity-like risk. We’d offer four key ideas for managing your municipal bond allocation in 2017:

- **Favor short to intermediate maturities** (7-10 years) for liquidity, flexibility and insulation from interest rate and policy uncertainty.
- **Consider flexible strategies** that allow you to be nimble and manage around interest rate and policy risks.
- **Look to the A-rated space**, which has outperformed the broader market since 2009.
- **Be choosy and diversify**. Not all credits are created equal. We see an advantage in owning a diversified, professionally managed portfolio of munis over single bonds.

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Munis can help offset equity risk

One-year correlation to various assets

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<tr>
<th>Treasuries</th>
<th>Invest.-grade</th>
<th>High yield</th>
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<tr>
<td>0.63</td>
<td>0.58</td>
<td>0.09</td>
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Source: Morningstar, as of Feb. 28, 2017. Correlations based on one-year daily total return. Treasuries represented by the Bloomberg Barclays Treasury Index, investment-grade by the Bloomberg Barclays Investment Grade Corporate Index, high yield by the Bloomberg Barclays U.S. High Yield 2% Issuer-Capped Index, equities by the S&P 500 Index, and munis by the Bloomberg Barclays Municipal Index.

Is the market overpricing tax reform?

Muni pricing puts tax rate at 25%

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Investment involves risk. The two main risks related to fixed income investing are interest rate risk and credit risk. Typically, when interest rates rise, there is a corresponding decline in the market value of bonds. Credit risk refers to the possibility that the issuer of the bond will not be able to make principal and interest payments. There may be less information available on the financial condition of issuers of municipal securities than for public corporations. The market for municipal bonds may be less liquid than for taxable bonds. A portion of the income may be taxable. Some investors may be subject to Alternative Minimum Tax (AMT). Capital gains distributions, if any, are taxable. Index performance is shown for illustrative purposes only. You cannot invest directly in an index. Past performance is no guarantee of future results.

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