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Municipal Bonds: 3 Ways To Invest That You May Have Forgotten

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Cities typically don't have a lot of coin lying around for projects, so they often turn to munis, and you can benefit. Here's how.

If you've ever had a job with a terrible commute, you know that road construction is like glitter -- once it gets on a city, it's almost impossible to get rid of, and it shows up everywhere.

Roadwork, of course, is just one kind of public works project that costs the average city millions of dollars. Usually, cities don’t have that kind of coin lying around with nothing to do, so they borrow the money. And one way to do that is to issue municipal bonds.

Municipal bonds give people like you the chance to lend money to cities and other municipalities. As the lender, you get one particular perk: The interest payments you'll receive are often exempt from taxes, especially if you live in the municipality that issued the bond. Issuers know this, and that's why the interest rates on munis are usually lower than the interest rates on "regular" bonds. That, in turn, encourages governments to undertake new projects.

#-ad_banner-#Regardless of how you feel about the traffic jams this may indirectly create, here are a few things you may not know about municipal bonds.

General Obligation Bond

A general obligation bond ("GO bond") is a municipal bond that finances a city's overall operations and public works. That is, the projects funded by the bonds don't generate revenue (such as parks or streetlights). Voters usually have to approve GO bonds. GO bonds usually have $1,000 or $5,000 face values and mature in five to 30 years. They typically pay interest semiannually, although some are zero-coupon bonds.

Municipalities typically issue GO bonds the same way any other bond is issued: through an underwriter that gives a written prospectus to buyers and facilitates a competitive bidding process. After municipal bonds begin trading, bond dealers across the country earn money by acting as intermediaries between buyers and sellers. Most people buy munis through a broker/dealer, but mutual funds are a common way to invest in general obligation bonds and other municipal bonds.

Municipal bond investment trusts (MITs) are another way to invest in a basket of municipal bonds. The Municipal Securities Rulemaking Board (MSRB), which the SEC oversees, regulates general obligation bond underwriters and dealers.

General obligation bonds don't have collateral; instead, they are backed by the full faith and credit of the issuer. The municipality repays you from its collection of property taxes, sales taxes, tolls, property sales, license fees and other revenues (or other debt). Theoretically, the municipality has unlimited taxing power and thus should never default on the bonds, but because it can't print currency (like the U.S. Treasury does), bankruptcy is a real possibility.

Revenue Bonds

Revenue bonds are municipal bonds that fund specific projects that generate revenue. Toll roads are great examples -- the tolls from the toll road fund the interest and principal payments. If the toll revenue is insufficient, however, the issuer might not be able to make the payments.

Revenue bonds usually have $1,000 or $5,000 face values and pay interest semiannually, although some are zero-coupon bonds. Typical maturities are one to 30 years. If you own one, you usually don't have a claim to the project's assets (i.e., you can't repossess the toll road if the payments are late). Revenue bonds may also have catastrophe call provisions, which allow the issuer to call the bonds if the revenue-producing facility is destroyed. For all these reasons, revenue bonds typically yield more than general obligation bonds because they carry added risks.

Public-Purpose Bonds

If you've ever gotten into a heated argument in a bar about whether the Raiders or the Chargers should move to L.A. and what a jerk the mayor is for wanting to/not wanting to pay for a new stadium, then congratulations, you're honing your debate skills about public-purpose bonds.

A public-purpose bond is a municipal bond that funds projects that benefit the general public rather than private groups or individuals. Determining what "benefits the general public" is controversial, but the rules of thumb often fall around whether private entities receive more than 10% of the proceeds and whether the project has broad social value.

The Tax Reform Act of 1986 created distinctions between public-purpose and private-purpose bonds in an effort to limit the tremendous temptation municipalities face to act as banks for private entities with projects that lack substantial social benefit. The act, which made private-purpose bonds taxable, quelled much of this temptation. Today, there are many kinds of public-purpose bonds (i.e., general obligation bonds, revenue bonds), but overall, these bonds fund projects such as roads, libraries and infrastructure rather than football stadiums.

The Investing Answer: One of the largest advantages of investing in municipal bonds is that the interest is usually exempt from federal, state and local taxes (especially if the investor lives in the state or municipality issuing the debt). Capital gains on municipal bonds are taxable, however.

For the most part, though, investors in high tax brackets can save a bundle by buying municipal bonds instead of "regular" bonds. This is why municipal bond issuers get away with offering bonds that have lower yields than taxable bonds, and it's also why there is usually stronger demand for municipal bonds in high-tax states. Beware, though: Tax legislation or even rumors about tax legislation can dramatically affect the value of munis. And as with all bonds, muni

prices rise when interest rates fall, and fall when interest rates rise.

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