



# Important Information about Investing in Municipal Bonds

Baird has prepared this document to assist clients in their understanding of municipal bonds, so that they can make informed decisions when buying or selling municipal bonds. Of course, your Baird Financial Advisor will explain the features, characteristics and risks of any particular municipal bond under consideration for your account.

## What are Municipal Bonds?

Municipal bonds are debt securities issued by states, cities, counties, school districts and other government entities or agencies. The proceeds from offerings of municipal bonds are used to finance capital projects such as schools, government buildings, transportation improvements, utilities, sewers, hospitals and subsidized housing, or to fund day-to-day operations. Interest payments on most, but not all, municipal bonds are exempt from federal income tax and, sometimes, state income tax. See “Tax Status of Municipal Bonds” below.

Municipal bonds typically fall into the following types:

- **General obligation bonds** – These bonds are backed by the “full faith and credit” of the government issuer, which has the power to tax residents to pay bondholders. General obligation bonds represent a promise by the government issuer to levy enough taxes as needed in order to pay interest and repay principal on the bonds. Local governments depend largely on property taxes for their revenues, while state governments depend primarily on income and sales taxes. The issuance of general obligation bonds is usually subject to voter approval.
- **Revenue bonds** – These bonds are not backed by the government’s taxing power but by revenues from a specific project or source, such as highway tolls, lease fees, or usage charges. Payment of interest and repayment of principal on the bonds therefore depends on the adequacy of the revenues derived from the project. Some revenue bonds are “moral obligation” bonds, in which the government issuer states that it may, but is not required to, cover any revenue shortfall to make payments on the bonds, subject to annual appropriations. Some revenue bonds are known as “double barreled” bonds because they are supported both by the revenues generated from the project and the government issuer’s general tax revenue.
- **Tax-backed bonds** – Like revenue bonds, these bonds are repaid from certain tax revenues, such as sales taxes, gasoline or tobacco taxes, hotel or tourist taxes, special tax assessments or incremental property taxes.



## Important Information about Investing in Municipal Bonds, *continued.*

- **Conduit, industrial development/revenue or private activity bonds** – A form of revenue bonds, these bonds are issued by a government entity as a conduit for the benefit of a business or non-governmental enterprise, such as a manufacturing company, developer, college, hospital or non-profit organization. The business or enterprise borrows the proceeds from the issuer in order to finance its project and agrees to repay the issuer. Revenues pledged by the business or enterprise are applied to pay interest and repay principal on the bonds. The government issuer is not responsible for making payments on the bonds if the business or enterprise defaults.
- **Housing bonds** – Housing bonds are issued by a state or local government housing authority to construct single or multi-family housing. The bonds are secured by a pledge of the rental or lease revenues or mortgage payments and often by a mortgage on the property.

### Special Types of Municipal Bonds

Some municipal bonds have special characteristics, which are described below.

- **Credit enhancements** – Some municipal bonds have credit enhancements, such as insurance, liquidity support, a letter of credit or other form of third party backing. Bond insurance or a letter of credit is typically provided by a municipal bond insurer or a bank that guarantees the payment of interest and repayment of principal. Liquidity support may provide a means for holders to tender their bonds to a third party at a stated amount. Credit enhancements have different terms and conditions and are only effective if the insurer, bank or other third party has the wherewithal to honor its commitment.
- **Variable rate demand obligations** – Variable rate demand obligations or “VRDOs” are longer-term bonds with interest rates that are typically reset weekly. VRDOs also have put features that allow holders to put their bonds back to a trustee at par on seven days’ notice. These weekly interest rate reset and put features give VRDOs short-term bond characteristics. VRDOs are generally backed by a bank letter of credit. See “Important Information About Variable Rate Demand Notes” located at [www.rwbaird.com/disclosures](http://www.rwbaird.com/disclosures).
- **Short-term municipal notes** – Some municipal securities are structured as short-term notes (i.e., having a maturity of three years or less). These notes can include bond anticipation notes, revenue anticipation note, tax anticipation notes and grant anticipation notes. Municipalities issue notes to stabilize their cash flows while they wait for other expected revenues.
- **Certificates of Participation** – A certificate of participation permits the holder to participate in a stream of lease payments, installment payments or loan payments related to buildings, land, facilities or equipment. These payments are usually subject to annual appropriation by the municipality.

## Important Information about Investing in Municipal Bonds, *continued.*

- **Original issue discount bonds** – Original issue discount (OID) bonds are issued at a price less than par or face value (which is the amount payable at maturity). An investor who purchased an OID bond at original issuance and holds it until maturity will receive the face value. The difference between the issue price and the face value is treated as income rather than capital gain if the bonds are held to maturity. The OID accretes over time, thus increasing the investor's tax basis. Zero coupon bonds do not pay any interest during the life of the bonds; rather, they are sold at a deep discount to their face value. The discount is considered imputed interest.
- **Premium bonds** – Premium bonds are issued at a price that is above par or the face value. An investor who purchases a premium bond and holds it until maturity will receive the face value. The premium is amortized over the term of the bond, which reduces the investor's tax basis. Investments in premium bonds normally yield less than bond's coupon interest rate.
- **Refunded/Pre-Refunded/Escrowed to Maturity Bonds** – Refunded bonds are outstanding bonds that are being refinanced through a new issuance of securities. The new issuance is often referred to as a "refunding" and the bonds being issued to refund outstanding bonds are referred to as "refunding bonds." In some cases, the proceeds from the new issuance are immediately applied to retire the refunded bonds. In other cases, the proceeds from the new issuance are often invested in US Treasury securities and federal agency securities and then placed into escrow to pay the debt service on the bonds being refunded on their scheduled call dates or maturity dates. Because these outstanding bonds are not being immediately refunded, they are often referred to as "pre-refunded, "advance refunded" or escrowed-to-maturity" bonds.
- **Build America Bonds** – Build America Bonds, or "BABs," are a recent type of taxable municipal bonds in which the municipal issuer receives a direct subsidy from the federal government to cover a portion of the issuer's interest cost. These are also known as "direct payment" BABs. Another form of BABs, called "tax credit" BABs, offers a tax credit to the holders on the interest they receive. Both types of BABs have the effect of lowering an issuer's borrowing costs.

### Tax Status of Municipal Bonds

Many municipal bonds are tax-exempt, which means that the interest paid on the bonds is exempt from federal income tax. Interest paid on municipal bonds may also be exempt from state income tax for investors who reside in that state. Because of their tax-exempt status, municipal bonds may have stated interest rates that are lower than fully taxable bonds. Tax-exempt municipal bonds may be suitable for investors in higher tax brackets and are generally not an efficient investment for tax-advantaged accounts such as an IRA or 401(k) account. Some tax-exempt municipal bonds, such as private activity bonds, may be subject to federal and/or state alternative minimum taxes.

Some municipal bonds are taxable because the government will not subsidize the financing of activities that do not provide a significant benefit to the public and for other reasons. Build America Bonds are



## Important Information about Investing in Municipal Bonds, *continued.*

another type of taxable municipal bonds. Direct payment BABs enable municipalities to issue taxable bonds and receive a rebate from the federal government on the interest costs, and tax credit BABs offer a tax credit to investors.

There may be special tax considerations associated with the sale of bonds that were purchased at a discount or premium to par. Please consult your tax adviser.

Tax-exempt municipal bonds are generally appropriate for those seeking current income that is exempt from federal and, for some bonds, state income tax. Due to the benefits of the tax exemption, municipal bonds typically pay interest at a lower rate than other fixed income securities, such as corporate bonds. Persons in higher income tax brackets may find tax-exempt municipal bonds an attractive investment. The tax-equivalent yield for a municipal bond is often used to compare the municipal bond to a taxable bond, such as corporate bond. The tax-equivalent yield for a municipal bond is the yield on the bond divided by the difference between 1 and the person's tax rate. Thus, all things being equal, for a person in a 35% federal income tax bracket, the tax-equivalent yield on a tax-exempt municipal bond with a yield of 4% would be 6.15%. Tax-exempt municipal bonds are generally less attractive to retirement accounts (such as 401(k)s or IRAs) or accounts that are not subject to tax because they cannot take advantage of the benefits of the fact that the interest is exempt from income tax and such bonds often pay a lower rate of interest than taxable bonds. However, tax-exempt municipal bonds may still be purchased by retirement and tax-exempt accounts if they are determined to be appropriate despite the fact that the tax exemption will not apply.

### Information About Municipal Bonds

Municipal bonds are "exempt securities" under the Securities Act of 1933. This means that offerings of municipal bonds do not need to be registered with the SEC and are not reviewed by the SEC, and a prospectus containing required information does not need to be delivered to purchasers in the offering. However, for many municipal bond offerings an "official statement" is prepared. An official statement is a disclosure document prepared by the issuer that includes information about the terms and structure of the bonds being offered, the purposes of the offering, how the bonds will be repaid, and financial and operating data about the issuer or other person obligated to make payments with respect to the bonds. A copy of the official statement for a particular municipal bond offering is available upon request from your Baird Financial Advisor.

There are important sources of information about municipal bonds. Information for each municipal bond offering (unless otherwise exempt) is available through the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA) portal at [www.emma.msrb.org](http://www.emma.msrb.org). The EMMA website is a free public access database contains the following information for municipal bonds:

- Official statements
- Annual financial and operating information



## Important Information about Investing in Municipal Bonds, *continued.*

- Notices of material events, such as payment delinquencies, defaults, draws on debt service reserves or credit enhancements, bond calls, defeasances, ratings changes, events affecting the tax status of the bonds, and material modifications to the rights of bond holders
- Real-time and historical trade data

Other sources of information may include local newspapers, municipal websites, research reports and search engines. Your Baird Financial Advisor may have access to other sources of information as well.

### Key Features and Characteristics About Municipal Bonds

Before buying a municipal bond, you should understand the bond's key features and characteristics, including the following:

- Coupon or interest rate and interest payment dates – What is the stated interest rate on the bond? Is it a fixed or variable rate? If the interest rate is variable, how and when does its change? When are interest payments made?
- Price and yield – Is the bond priced at a premium or discount to par and what is its current yield, yield to maturity or, if applicable, yield to call?
- Maturity date – When does the bond mature?
- Repayment rates – Is principal repaid at maturity or at different dates prior to maturity?
- Call/redemption rights and sinking fund provisions, if any – Does the bond have call provisions entitling the issuer to retire all or some of the bonds? If so, is the call optional or mandatory and at what price(s)?
- Source of funding to make interest and principal payments – Who is responsible for making payments on the bond and what are the sources of funding to make those payments?
- Security (such as a mortgage, lien on assets or pledged revenues), if any – What are the revenues and other assets used to secure the bonds?
- Bond insurance or other credit enhancement (such as liquidity support, letter of credit or other form of third party backing), if any – Are payments on the bond insured or backed by a letter of credit? Is the bond's liquidity supported by a letter of credit or standby bond purchase agreement? Is the insurer, letter of credit provider or other third party backing the bond credit worthy?
- Bond rating from an independent credit rating agency and any recent ratings changes – Is the bond rated and if so is the rating "investment grade" or "below investment grade?" What does the rating mean? Have there been any recent ratings changes and if so why? It is important not to rely solely on credit ratings.
- Financial condition of the issuer or repayment source – What is the current financial condition of the issuer or other person obligated to make payments with respect to the bond and does its financial condition appear to be sufficient to make payments on the bond? Are there any anticipated declines or changes in the issuer's tax base or other sources of revenues to meet debt service obligations?



## Important Information about Investing in Municipal Bonds, *continued.*

- Any recent material event notices or filing delinquencies – Material event notices can suggest weakness or possible default. Filing delinquencies may be another “red flag.”
- Repayment priority – Do other bonds take precedence for repayment? Does that impose a risk of possible non-payment of the bond?
- Tax status (federal and/or state tax-exempt, taxable, AMT) – Is interest on the bond exempt from federal income tax and/or state income tax? Is interest on the bond subject to alternative minimum tax?

Your Baird Financial Advisor is able to explain a bond’s key features and characteristics to you.

### Risks Associated with Investing in Municipal Bonds

Municipal bonds are subject to various risks, as described below. You should refer to the official statement for the particular municipal bonds that you are considering buying for information on the specific risks of those bonds.

- **Credit/Default risk** – Municipal bonds entail the risk that the issuer that the issuer or other party responsible for making payments on the bonds may experience financial problems that make it difficult or impossible to pay interest and principal in full. Although municipal bonds have traditionally experienced low rates of default, defaults do occur, and may be more common during periods of economic weakness and declining property values as many municipalities struggle with reduced revenues, significant post-employment obligations and other costs and strained budgets. Default risk is generally greater with revenue or conduit bonds than with general obligation bonds because full payment on the bonds depends on the amount of revenues generated from the project being financed or the financial success of the business, enterprise or facility responsible for making payment. Credit risk is reflected in a bond’s rating, with higher rated bonds generally seen as having a lower credit risk. Bonds backed by insurance or other credit enhancement may add an extra layer of protection, although such protection is only as good as the creditworthiness of the insurer or other third party backing the bonds.
- **Interest rate/market risk** – The prices of municipal bonds will move in the opposite direction as changes in prevailing interest rates. Thus, if prevailing interest rates rise, the market prices of municipal bonds will decline, and vice versa. Longer-term bonds are more susceptible to interest rate changes than bonds with shorter maturities. Some municipal bonds may pay interest at a variable rate, so the interest rate you receive will fluctuate based on prevailing interest rates and other factors such as time to maturity or call.
- **Inflation risk** – Bonds run the risk that their yields may not provide a positive return over the rate of inflation during the period of investment.
- **Liquidity risk** – Municipal bonds are subject to the risk that there may not be an established secondary market for them. Municipal bonds are not traded on an exchange or other centralized market; they are traded in an over-the-counter market between dealers. At times, municipal bonds may



## Important Information about Investing in Municipal Bonds, *continued.*

be difficult to sell. In addition, smaller positions in municipal bonds may be more difficult to sell than larger positions and may need to be sold at bigger discounts.

For more information on liquidity risk, see the FINRA Investor Alert, “Bond Liquidity – Factors to Consider and Questions to Ask,” at <http://www.finra.org/investors/alerts/bond-liquidity-factors-questions>.

- **Call risk** – Some municipal bonds have call provisions that allow the issuer to retire or redeem the bonds prior to their stated maturity. Issuers typically call bonds when prevailing interest rates decline, making it difficult for holders to reinvest the proceeds at the same rates they received on the bonds prior to their redemption. Often, only a portion of bonds are called and there are different methods for determining which bonds will be called. There is thus no assurance that if bonds are called the specific bonds you hold will be among those called. The risk of a possible call can also adversely affect the market price of a bond.
- **Appropriations risk** – For some municipal bonds, amounts needed to make interest and principal payments must be appropriated annually by the issuer. These bonds are therefore subject to the risk that the government issuer may not make the necessary annual appropriation.
- **Event or Political risk** – Municipal bonds are subject to the risk of a natural catastrophe, accident, adverse political, legislative or regulatory development, major lawsuit or other event beyond the issuer’s control. If such events occur, the bonds may be called or subject to default.
- **Tax risk** – Tax-exempt municipal bonds may be subject to the risk that an adverse opinion, ruling, or legislative or regulatory development, or that an action taken or not taken by the issuer, could cause the interest on the bonds to be taxable.

### Additional Resources

Your Baird Financial Advisor would be pleased to answer any questions you have about municipal bonds generally and about any particular municipal bonds you may own or may be considering. In addition, there are a number of resources available to you to help you learn more about municipal bonds, including:

- **Municipal Securities Rulemaking Board ([www.msrb.org](http://www.msrb.org))** – The MSRB website contains information about the municipal bond markets and investor education materials, including a document entitled “Seven Questions to Ask When Investing in Municipal Bonds” and a glossary of municipal securities terms.
- **Electronic Municipal Market Access ([www.emma.msrb.org](http://www.emma.msrb.org))** – The EMMA website contains an “Education Center” that provides helpful information about municipal bonds generally. The EMMA website also contains information about specific municipal bonds, including official statements, financial and operating information, material event notices and trade data.



## Important Information about Investing in Municipal Bonds, *continued.*

- **Investinginbonds.com** – This website, sponsored by the Securities Industry and Financial Markets Association (SIFMA) provides educational material about municipal bonds and real-time information about the municipal bond markets.
- **FINRA** – ([finra.org](http://finra.org)) – This website contains both information about bond investing generally and about investing in municipal bonds.
- **Securities and Exchange Commission** ([www.sec.gov](http://www.sec.gov)) – The SEC publishes investor bulletins focused on municipal bonds from time to time.
- **Municipality websites, local newspapers, search engines** – Municipal issuers generally have websites that contain financial and other operating data, as well as board and committee meeting materials. Local newspapers may also have articles about a particular municipality. Common search engines, such as Google or Bing, can also be used to find information about municipal bonds.