Why Municipal Bonds Probably Don't Belong In Your Portfolio

I recently received a request from a reader that I write a bit about municipal bonds. I'm not a huge fan of municipal bonds for several reasons I'll list out below, but first, a brief description for those who have no idea what I'm talking about.

A municipal bond is a loan to a local or state government. The government might use it for schools, a stadium or some other purpose. It is guaranteed by the state or local government, which has the ability to raise taxes to pay the bond, so it is generally considered safer than loaning money to a company. But it is much riskier than loaning to the federal government, which not only has the ability to raise taxes, but also to print money in order to pay the interest and principal on the bond.

In order to encourage investors to buy munis, the federal government makes the interest on (most of) them federal-tax-free. If it is a bond in your state, it is also usually state-tax-free. This can be a pretty good deal for those in a high tax bracket (especially in a high-tax state such as California or New York.)

Now, the reasons why you probably shouldn't put these in your portfolio.

1) Bonds should generally be placed into tax-protected accounts

Most investors, and in fact most doctors, can and should be investing almost entirely inside tax-protected accounts such as 401Ks, IRAs, and Roth IRAs. I make more than the average physician, save more than most doctors, and still find little need for a taxable investing account. It usually makes no sense to hold munis inside retirement accounts, so I have no need for munis. Even if you do have a sizable taxable account, you still probably have room to have your entire bond allocation in your retirement accounts, and don't have a need for munis.

The reasoning for this comes down to the fact that stocks receive preferential tax treatment compared to bonds. The dividends and long-term capital gains are only taxed at a maximum of 15% whereas bond income is taxed at your regular marginal tax rate (same as your regular pay.)

2) Munis can and do default.

Defaults aren't nearly as common as with corporate bonds (especially junk bonds), but they do occur. Counties and cities go bankrupt from time to time and many political commentators are even speculating that large states such as California or Illinois could go bankrupt in the future. That isn't necessarily a huge problem, and can usually be overcome (at least at the local level) for many people by using a mutual fund. But if your entire bond portfolio is invested in California state muni bonds and California defaults on them…..you're just out of luck.

3) Most of the time you have to pay state taxes anyway

Most states don't have a low-cost muni bond fund available. Vanguard, for instance, only offers tax-exempt bond funds for California, Florida, Ohio, Massachusetts, New York, New Jersey, and Pennsylvania. No dice if you're in another state with a state income tax; You can get a generic muni-bond fund (federal tax-free, but not state tax-free), but you'll have to pay state taxes on it. There's a fund available in my state, but it has a 4% load and an ER of 0.83%. Considering the current yield is only 3.94%, it'll probably take me a year and a half just to break even on my investment, and that's before inflation. No thank you.

4) Your mutual fund options are limited

As discussed above, there aren't very many options for muni bond funds. Even if you can find a low-cost state-specific muni bond fund, you probably can't get one with the duration you want. It's rare to see a long-term, medium-term, and short-term bond fund for your state. There's also a good chance you won't be able to find an index mutual fund. You'll likely be stuck with a high-cost, actively-managed fund.

5) Buying individual muni bonds is a poor option.

While it is now cheap and easy to buy stocks with minimal commissions and spreads, it is still quite difficult to do that with individual muni bonds. These bonds aren't very liquid, so commissions and spreads are high, and that's if you can find a buyer at all. I assure you the baby in the eTrade commercials isn't trading muni bonds with a click or two of the mouse. You also need to buy a lot of them to get proper diversification. Not only does that increase your costs, but it also increases the hassle factor of implementing and maintaining a portfolio.

6) You double-down on local economy risk

Most informed investors are aware that their portfolio shouldn't hold much, if any, of the stock of the company they work for. It's also a bad idea to have a portfolio entirely made up of the stocks and bonds of local firms. Muni bonds have similar issues. If you want the best tax treatment, you have to buy bonds from your own state. If your state economy tanks, not only is your regular income threatened, but now the value of your portfolio is hurt at the same time. Investing in muni bonds violates an important rule of investing: Don't put all your eggs in one basket.

7) Muni bonds can be a poor choice if you're in a low tax bracket

In order to decide whether to buy a muni bond or a non-muni bond with similar risk, you have to divide the yield on the non-muni bond by your marginal tax rate. For example, if the muni bond yields 4.5%, the non-muni bond yields 6%, and your marginal tax rate is 35%, you multiply 6% by 1-0.35= 3.9%. You'd be better off with the muni bond. But if your marginal tax rate is just 15%, then the non-muni bond has an after-tax yield of 5.1%, far better than the muni bond. Yields change and tax brackets change, so you need to periodically do this calculation to make sure your muni portfolio still makes sense for you.

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