MSRB

# Facts about Municipal Bonds

Investors who are considering buying a municipal bond may find it helpful to learn about the characteristics, features and pricing of municipal bonds.

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## Tax Status

Municipal bonds are often referred to as tax-exempt bonds because the Internal Revenue Code provides an exclusion from gross income for tax purposes for most municipal bonds. The interest received by an investor from a municipal bond typically is free from federal and, in some cases, state and local personal income taxes for residents who own bonds issued in their state. Municipal bonds are not free from all tax implications. It is important to consult your tax advisor concerning the tax implications of the municipal bonds you may purchase.

## Interest

Interest is the annual rate, expressed as a percentage of principal, an investor will receive on a bond. An interest rate also is referred to as a coupon rate. Interest does not take into account any discount or premium in the purchase price of a bond.

## Yield

Yield is the annual return an investor receives on a bond, taking into account the purchase price of the bond. Current yield is the ratio of the annual dollar amount of interest paid on a bond to its purchase price, stated as a percentage. For example, a $10,000 bond with an interest rate of 5 percent purchased at par would have a current yield of 5 percent and pay $500 in interest each year.

**Yield-to-maturity** is the amount of money an investor earns from payments of principal and interest, if the bond is held to maturity, with interest compounded semiannually at the stated yield. Yield-to-maturity takes into account the premium or discount, if any, in the purchase price of the bond and the time value of the investment.

**Yield-to-call** is the rate of return the investor earns from payments of principal and interest, with interest compounded semiannually at the stated yield, presuming the bond is redeemed on a specific call date. Yield-to-call takes into account the premium or discount, if any, in the purchase price of the bond, any applicable premium paid on the call date, and the time value of the investment.

## Bond Prices

The amount an investor pays to purchase a bond is the bond price. Bonds are priced in one of three ways — at par, at a discount and at a premium — depending on prevailing interest rates, demand for the bond, its credit rating and other market factors. A bond's interest rate will affect the price an investor pays for a bond.

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Bond prices are usually expressed as a percentage of the face value of a bond, or the amount of principal that an investor will receive at maturity of the bond. This amount is also referred to as par value. For example, if an investor buys a bond with a face value of $10,000 and holds it to maturity, the investor will receive $10,000 face value, together with any interest coming due. Investors should understand that if they sell a bond prior to maturity the price they receive may be less than the repayment of the principal amount initially paid due to market interest rate changes or changes in the credit profile of the issuer or security, among other factors.

*Market interest rate changes affect the price at which a bond may be bought or sold in the secondary market.*

A bond priced above par is referred to as a premium bond. In the example above, an investor might pay $12,000 for $10,000 par value of bonds. A bond priced below par is called a discount bond. In this case, an investor might pay $9,000 for $10,000 face value of bonds.

Market interest rate changes affect the price at which a bond may be bought or sold in the secondary market. When market interest rates decrease, a bond rises in value. If interest rates increase, a bond falls in value. Whenever interest rates change, the market will price a bond with a fixed interest rate so that it provides approximately the same return as an equivalent, newly issued municipal bond with a higher or lower interest rate.

The longer a bond's maturity, the more likely that its price will fluctuate based on market interest rates. The chance that a bond's price will change as market interest rates change is called interest rate risk. Longer-term bonds are more susceptible to interest rate risk because of the long period of time that exists during which interest payments on the bond may not match market interest rates. To compensate for this risk, the market price of a bond changes depending on the movement of market interest rates. Investors can mitigate interest rate risk in part by buying bonds with shorter maturities or by holding the municipal bond to its maturity date.

## Maturities

Municipal bonds are issued in maturities, often falling within the range of one to 30 years. Some state and local governments issue "serial" bonds, which are groups of bonds with a series of maturity dates, typically with maturities occurring each year. Serial bonds typically may mature in one to 20 years. Term bonds are repaid in a single or limited number of maturity dates and typically may mature in the 20- to 30-year range.

Investors should be aware of the maturity of a bond they are purchasing because, as noted above, selling a bond prior to its stated maturity can result in the investor receiving a price other than the original amount invested. For example, if an investor purchases a bond with the goal of selling it in 10 years, he or she would want to consider purchasing a bond with a 10-year maturity rather than one with a 30-year maturity.

## Interest Payment Date

The date on which investors are entitled to receive interest payments is known as the interest payment date.

## Call Provisions

A municipal bond may have an early redemption provision, also known as a call provision, that allows the state or local government that issued the bond to redeem it before the stated maturity date at a specified price. In these cases, the investor receives the principal amount of the bond and, in some cases, an additional premium.

## Denominations

Municipal bonds are typically sold in denominations in multiples of $5,000.

## CUSIP Number

A CUSIP number is the unique identification number assigned to each maturity of a bond issue and is a nine-character identifier that includes both numbers and letters, *e.g.*, 123456AA2.

## Primary Offering

When a state or local government issues a new bond, the sale is often referred to as the initial offering, primary market sale or primary offering.

## Secondary Market

A sale of bonds sold after the primary offering is typically considered a secondary market trade.

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