Why municipal bond diversification matters

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Based on historical default rates, municipal (or muni) bonds generally have good credit quality compared to corporate bonds. But they do still have risk — specifically, the risk of default, which is called credit risk. By owning bonds from different types of borrowers, you can spread that credit risk among your bonds.

When building a municipal bond portfolio, we recommend diversifying by sector, issuer, maturity and geography.

Muni sectors are defined by the source the municipality will use to pay back the debt. Since municipal bonds may behave similarly to other bonds of the same sector, diversifying by sector may provide stability and reduce credit risk. The Edward Jones Investment Policy Committee has outlined the following distinct sectors:

1. General obligation (GO) bonds

General obligation (GO) bonds may be backed by a state or local government's full faith and credit, but they are typically backed at least by some combination of taxes and other available funds. While the legal meaning of "general obligation" varies by state, a GO pledge is typically backed by a broad willingness to highly prioritize principal and interest payments. There may be limitations on the tax rate a municipality can levy, which is commonly referred to as a limited-tax GO.

2. Revenue bonds

Revenue bonds finance a specific project that will generate revenue for the municipality, such as a toll bridge, highway or hospital. The bonds are secured by that specific revenue source.

- **Utility revenue bonds** include water, sewer, natural gas, solid waste and public power. Municipal utilities typically benefit from minimal competition, unregulated rate-setting authority and the essential services they provide.
- **Tax-backed revenue bonds** are secured by specified taxes that are dedicated for repayment. Common types of backing for these bonds include taxes on sales, income, property, motor vehicles and public utilities.
- **Transportation and other revenue bonds** include airport, port authority, highway, mass transit, parking, bridge and toll road bonds, plus other miscellaneous sectors. Transportation projects can play an essential role in supporting the economy and, in turn, benefit from economic growth that generates demand for transportation.
- **Education revenue bonds** are issued from public and private schools, colleges and universities. Public schools typically benefit from diverse revenues, including local, state and federal funding, and the essential education they provide. Public colleges and universities generally have diverse revenues, such as state and federal funding, tuition and alumni support. Private colleges typically rely on tuition, alumni support and endowments.
- **Health care revenue bonds** are issued by hospitals and other health care providers, including nursing homes. These providers typically deliver essential services, though challenges can include low reimbursement rates from government payers and rising expenses.
- **Housing revenue bonds** are issued to finance single-family, multifamily, senior, student and military housing. These bonds are typically backed by payments from mortgages on the properties financed. Bonds issued by state and local housing finance agencies may receive additional support.

Building a muni bond portfolio

We recommend you consider GO bonds for a significant portion of your municipal bond portfolio. Historically, they have had very low default rates and are backed by the borrowing and taxing power of the issuer. However, we still believe revenue bonds should be part of a diversified muni bond portfolio.

We recommend starting with revenue bonds for sectors that provide essential services, such as utilities and transportation. We believe essential-service revenue bonds may provide greater protection in the rare case of a municipal bankruptcy because they are backed by defined and dedicated revenues. Additionally, issuers of these bonds typically do not have significant pension or health care obligations, which have reduced recoveries to GO bondholders in some bankruptcies.

By owning GO and essential-service revenue bonds, you are diversifying by payment source.

Diversify by issuer and sector

In addition, your muni bond portfolio should be diversified by issuer and sector (e.g., utility, tax-backed, education, transportation, housing and health care) to help limit the risks associated with overconcentration in any one issuer or sector. We recommend no more than 80% of your muni bonds be invested in GO bonds and no more than 70% in revenue bonds. And no single obligor — the entity responsible for making the interest and principal payments — should make up more than 5% of your total portfolio.

The table below details our municipal bond sector recommendations. This guidance is based on the overall representation of these types of bonds in the marketplace as well as the relative credit risk of each sector. Keep in mind, the exact mix of muni bonds appropriate for your portfolio will depend on your unique situation and financial goals.

Recommended ranges for muni bonds

Bond type	Recommended range
General obligation (GO) bonds	30% – 80%
Revenue bonds	20% – 70%
Utilities	10% – 25%
Tax-backed	5% – 20%
Transportation and other	5% – 20%
Education	0% – 10%
Health care	0% – 5%
Housing	0% – 10%

Location, location, location

We also recommend diversifying your bonds by geography. Making sure your bonds aren't all from one state or region can help you reduce risk. In some cases, depending on your tax rate and current market conditions, the after-tax return of an out-of-state bond may be similar to that of a bond from your own state. So, it may be a good strategy to accept a slightly lower rate to diversify into bonds from other states.

On the other hand, if you're in the highest tax bracket and live in a state with a high tax rate, investing outside your state may mean giving up a significant rate advantage. Nevertheless, it's important to understand you may be taking on more risk by concentrating your bonds in one geographic area. If you choose to accept that risk, we would recommend you diversify your bonds geographically within your state.

Focus on fixed-income principles

We expect the muni bond market to experience periods of volatility from time to time because of credit quality concerns, supply and demand, and rising interest rates. By sticking with bonds of investment-grade quality, laddering bond maturities and managing the sector diversification of your muni bond portfolio today, you'll be better prepared for whatever may happen tomorrow.

