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INVESTMENT PERSPECTIVES

5 reasons to invest in today's muni bond market

Key takeaways

- Muni bonds have offered resilience during recent periods of rising interest rates.
- The correlation between munis and U.S. stocks has been low, about 0.1 during the 10 years through July 2017, offering a source of diversification.
- Managed muni bond funds can benefit from in-depth credit analysis and also from the consideration of liquidity.

Many investors understand municipal bonds can be a source of tax-advantaged income, but that’s just one reason to consider them for client portfolios. Clients looking for investments offering relatively resilient returns in times of rising interest rates, relative value opportunities, or diversification from equity exposures might be well served with munis.

In today’s muni market, credit risk is a primary driver of bond valuations, and buying and selling bonds can be costly and difficult for smaller investors. A research-driven approach to investing can, therefore, add value. With all that in mind, here are five reasons to consider investing in munis:

1. Potential resilence around periods of rising rates

Since bond prices move inversely to yields, many investors are concerned by the prospect of rising interest rates. However, history offers food for thought. For example, in two recent periods when the Federal Reserve raised the federal funds rate and five-year Treasury yields rose more than two percentage points, the muni market recorded positive returns from the start of each period through one year after the period ended. It's also important to remember that rising yields may actually benefit managed muni bond funds – enabling reinvestment in issues offering higher income and, therefore, possibly greater longer term potential returns.

Rising treasury yields are bad news for munis? Not necessarily.
Municipal bond market cumulative total returns through two periods of rising yields*

Sources: Bloomberg Index Services Ltd. Capital Group.

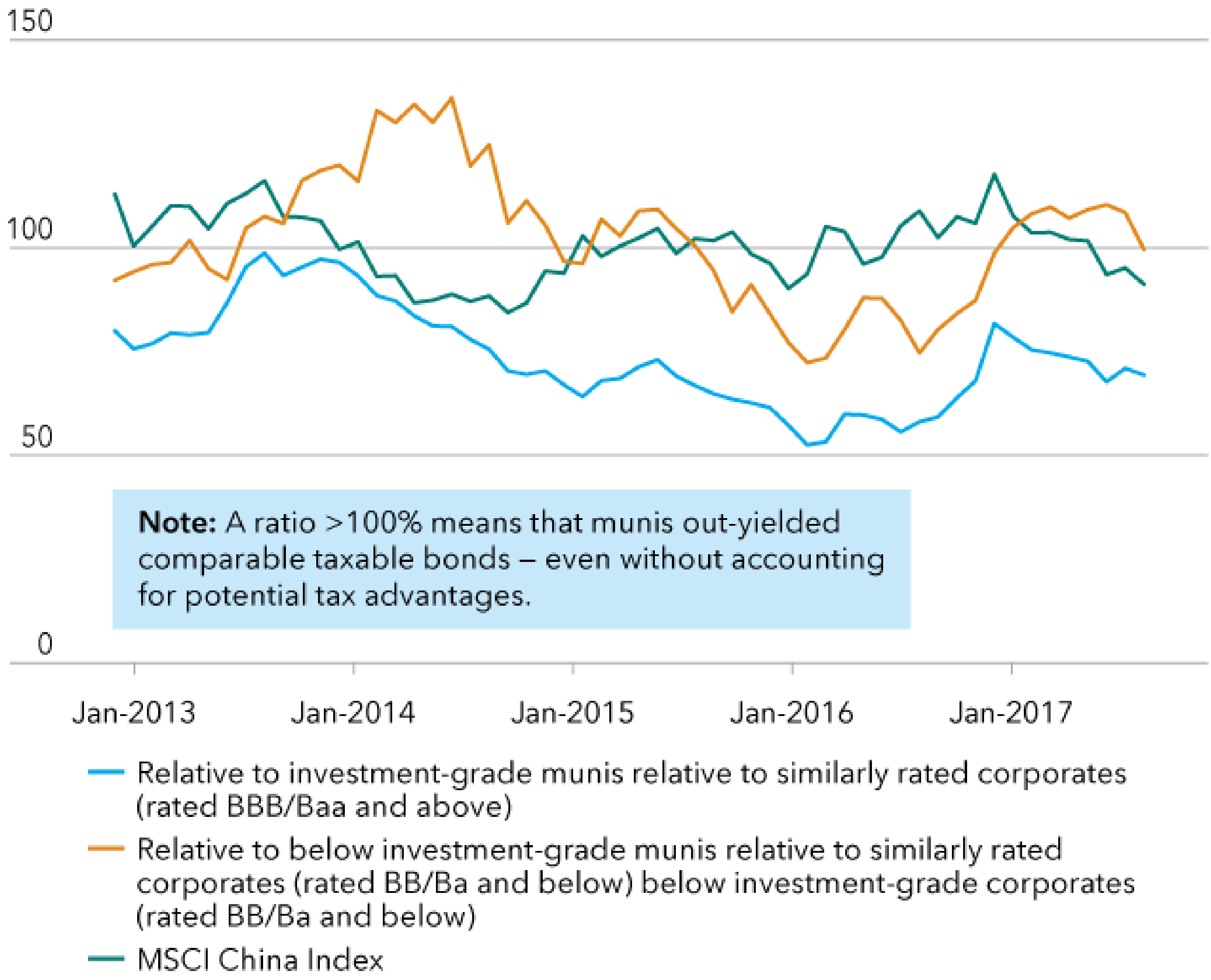
** Two most recent periods in which five-year Treasury yields rose by more than two percentage points, low to high, over a period lasting more than 12 months. Yields have risen by more than two percentage points in periods other than those presented. Investment- and below investment-grade muni returns represented by Bloomberg Barclays Municipal Bond Index and Bloomberg Barclays Municipal High Yield Index, respectively. Indexes are unmanaged and therefore have no expenses. Investors cannot invest directly in an index.*

2. Good relative value – especially in high-yield munis

Depending on an investor's net tax burden, some investment-grade munis have recently offered yields that are comparable to those of similarly rated corporate bonds. Meanwhile, muni yields have appeared especially attractive relative to Treasuries. Ratios of below investment-grade muni yields relative to similarly rated corporates have averaged around 100% over the last couple of years.

Tax yields appear attractive given potential advantage

Ratio of before-tax muni yields to corporate and treasury yields



Source: Bloomberg Index Services Ltd. Ratios, expressed as percentages, of yield-to-worst of Bloomberg Barclays Municipal Bond Index compared to Bloomberg Barclays U.S. Corporate Investment Grade Index, Bloomberg Barclays 10-Year Municipal Bond Index compared to 10-Year U.S. Treasury yields, and Bloomberg Barclays Municipal High Yield Index compared to Bloomberg Barclays Corporate High Yield Index, through December 31, 2016. The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in indexes.

3. Diversification potential for stock-heavy portfolios

Many investors could benefit from the diversification potential of munis. Over the 10 years through July 2017, for instance, municipal bond returns had a very low correlation with stock returns. This characteristic suggests that the addition of munis to a wider investment mix that includes a significant exposure to equities, may help smooth out overall volatility.

Munis offer low correlation
Ratio of before-tax muni yields to corporate and treasury yields

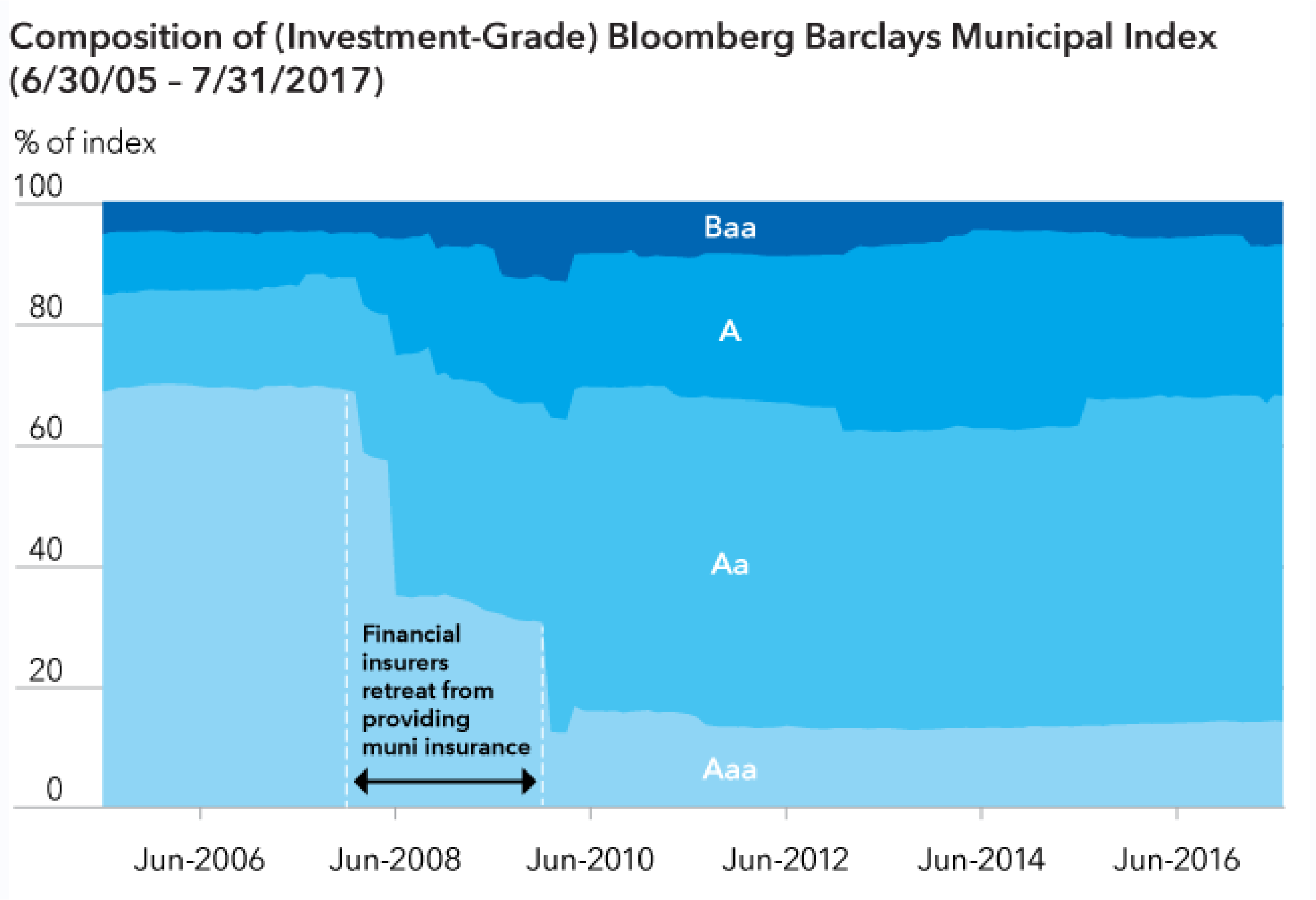
Source: Capital Group.

** Correlation between returns for muni bonds (represented by the Bloomberg Barclays Municipal Bond Index) and U.S. stocks (Standard & Poor's 500 Composite Index) for the 10 years through July 2017. Correlation is a mathematical concept used to describe how closely changes in the returns of different asset classes mirror each other. The degree of closeness is measured on a scale running from –1 to +1. A correlation of –1 indicates that the two returns tend to move by equal but opposite amounts (for example, if the correlation between Asset X and Asset Y is –1, then when X rises by 10%, Y will tend to fall by a similar percentage). A correlation of +1 indicates that the two assets' returns tended to move up or down in lockstep. A correlation of zero indicates no relationship between the returns of each asset class.*

4. With munis now a credit market, research is crucial

General obligation (GO) muni bonds are typically backed by the credit and taxing power of a state or local authority. However, revenue bonds (backed by a specific revenue stream of the issuer that is used to service the debt obligation) actually account for most of the market. Many revenue bonds – such as those linked to airlines or toll roads, for instance – are therefore closely tied to the credit quality of corporate and nongovernmental entities. So, with munis now more of a credit-driven market, collaborative research – where muni investment professionals work with colleagues from equity and taxable-bond investment teams – can add deep insights.

Munis have transformed from a safe haven to a $3.8 trillion credit market

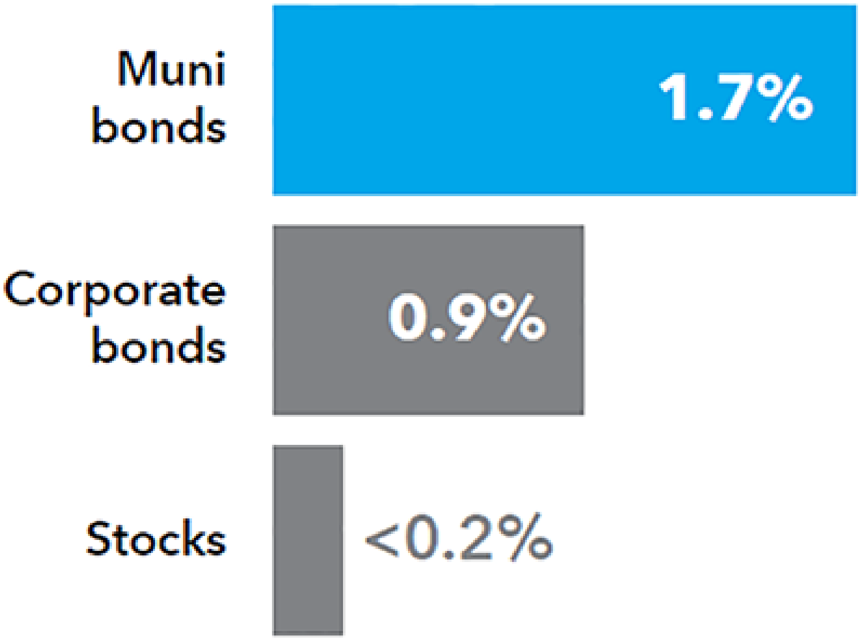


Source: Bloomberg Index Services Ltd. As of July 31, 2017. Total municipal bond market size is about $3.8 trillion; investment-grade index includes in excess of 50,000 issues, worth around $1.4 trillion.

5. With munis now a credit market, research is crucial

A lack of liquidity in the muni market tends to be associated with wide bid-ask spreads for investors dealing in smaller deal sizes. In effect, a wide spread means there's a higher embedded cost to buying and selling an asset, over and above brokerage fees. In contrast, institutional investors are often able to work with multiple dealers and transact at much lower costs – a potentially meaningful advantage (alongside diversification) from which investors in muni funds may benefit.

Lower liquidity in munis may be a rude awakening for many investors
Average bid-ask spread for individual investors in bonds and stocks



Source: Spread measures the maximum difference in price for buying from and selling to a broker, here for bond trades of $100,000 or less and stock trades of all sizes. Analyses appeared in "Muni Bond Costs Hit Investors in Wallet," March 10, 2014, The Wall Street Journal. Bond anlaysis from S&P Dow Jones Indices; stocks anlaysis from Credit Suisse Trading Strategy.

Fund	F-3 Ticker Symbol	Inception Date	1 Year	3 Year	5 Year	10 Year	Expense Ratio
The Tax-Exempt Fund of California®	EXCAX	10/28/1986	-0.71	3.55	3.98	4.73	0.37
American Funds Tax-Exempt Fund of New York®	TFNYX	11/1/2010	-0.99	3.49	3.20	-	0.48 gross/0.45 net
The Tax-Exempt Bond Fund of America®	TFEBX	10/3/1979	-0.56	3.45	3.62	4.49	0.31
American High-Income Municipal Bond Fund®	HIMFX	9/26/1994	0.47	5.26	5.55	4.97	0.39
Limited Term Tax-Exempt Bond Fund of America®	FLTEX	10/6/1993	0.23	1.68	1.96	3.50	0.31
American Funds Short-Term Tax-Exempt Bond Fund®	SFTEX	8/7/2009	0.50	0.82	0.91	-	0.45

The investment adviser is currently reimbursing a portion of other expenses for American Funds Tax-Exempt Fund of New York. Investment results and net expense ratios reflect the reimbursement, without which the results would have been lower and the expense ratios would have been higher. This reimbursement will be in effect through at least September 30, 2017, unless modified or terminated by the fund's board. The adviser may elect at its discretion to extend, modify or terminate the reimbursement at that time. Please see each fund's most recent prospectus for details. Investment results for the American Funds Short-Term Tax-Exempt Bond Fund prior to August 7, 2009 (during the period it operated as a money market fund) can be found in the fund's prospectus.

Class F-3 shares were first offered on January 27, 2017. Class F-3 share results prior to the date of first sale are hypothetical based on Class A share results without a sales charge, adjusted for typical estimated expenses. Please see each fund's prospectus for more information on specific expenses.

Bond ratings, which typically range from AAA/Aaa (highest) to D (lowest), are assigned by credit rating agencies such as Standard & Poor's, Moody's and/or Fitch, as an indication of an issuer's creditworthiness.

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Figures shown are past results and are not predictive of results in future periods. Current and future results may be lower or higher than those shown. Share prices and returns will vary, so investors may lose money. Investing for short periods makes losses more likely. View fund expense ratios and returns.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value.

Investors should carefully consider investment objectives, risks, charges and expenses.

This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

The return of principal for bond funds and for funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings.Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal than higher rated bonds.

Income from municipal bonds may be subject to state or local income taxes and/or the federal alternative minimum tax. Certain other income, as well as capital gain distributions, may be taxable.

Investment results assume all distributions are reinvested and reflect applicable fees and expenses.

When applicable, investment results reflect fee waivers and/or expense reimbursements, without which results would have been lower.

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Expense ratios are as of the most recent prospectus.The expense ratio for the F-3 share class is estimated.

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