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Intelligent Money

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Current thinking from Haven Financial Advisors

Municipal Bonds and your Portfolio

Municipal Bonds tend to fall below the radar screen of most Texas investors. Our state has no state income tax and that, fortunately, limits the tax liability of its residents. However, over the past 24 months taxable money market yields have fallen relative to their tax-exempt cousins. At longer maturities, there has been a similar convergence of interest rates between taxable and tax-exempt instruments. In the 1990s, the 10-year treasury note on average yielded 0.94% more than a like maturity AAA-rated municipal bond. That spread collapsed to 0.21% by January 17th, 2003.

Maturity	*Treasury Yield(%)*	*Tax-Exempt AAA(%)*	*Corporate AAA(%)*
3 mo	1.15		
6 mo	1.20		
1 yr	1.24	1.18	1.74
2 yr	1.63	1.38	2.18
3 yr	2.10	1.71	2.52
5 yr	2.97	2.48	3.69
7 yr	3.47	3.25	4.40
10 yr	4.02	3.81	4.37
20 yr	4.98	4.66	5.95
30 yr	4.92	4.87	5.96

Supply and demand factors are driving these spreads down. Tax-exempt product is flooding the market and that is depressing prices as treasuries rally. Municipal bond issuance reached a record $302.4 billion in the first three-quarters of 2002, topping the previous record of $264.3 set in the same period of 1993. Budget gaps resulting from lowered tax receipts have forced states and localities to borrow more to finance new investment.

Fixed–income securities are issued by several major entities in the United States. The US treasury, its federal agencies, corporations, states, and municipalities are the best known. The interest on bonds issued by states and municipalities is exempt from federal taxes. And right now, tax-exempt yields are nearly as high as those issued by the US government.

There are practical opportunities associated with the convergence of money market yields. One way to take advantage is by filling out a simple form. Most investors are offered several "sweep" options for their brokerage accounts. The sweep account invests the cash balances for the client. Currently, $5 trillion is so invested. Choices typically include both taxable and money market instruments. Most investors today, including Texans, should give serious thought to selecting a tax-exempt money market fund as the vehicle for their cash balances. That advice does ***not*** extend to the money market investments of tax-deferred vehicles such as IRAs and qualified plans.

With respect to longer term fixed-income investments, there is no clear cut strategy. AAA-rated municipal bonds indeed offer compelling value relative to treasuries. However, most middle and upper income Americans already have access to qualified retirement plans and IRAs that defer taxation. By concentrating their fixed-income asset allocation in these accounts, investors utilize the tax shelter rather than the investment vehicle's tax exemption.

Older investors may require income from

Special Notes of Interest:

- Texas is one of only seven states without a personal income tax. The others are Alaska, Florida, Nevada, South Dakota, Washington, and Wyoming.
- A high-earning resident of New York City in 2002 would have had a marginal income tax rate of 48.45% when federal, state and local taxes are included.

Municipal Bonds (continued)

assets in taxable accounts. This may be especially true of those with a life interest in a trust. The trust should be invested to offer current income. For these older investors, municipal bonds offer superior after-tax yields to treasuries under today's market conditions.

Treasury Bonds are by no means a straw man to serve as a foil to municipal bond yields. The Treasury market is the largest and most liquid market in the world … but there are other fixed income assets for investors. Today AAA corporate bonds are trading at wide spreads to Treasury Bonds. Their after-tax returns are competitive with municipal bonds even for folks in high tax brackets.

Some equity securities also offer attractive yields with the added salutary effect of diversification. Utilities and Real Estate Investment Trusts (REITs) both have income yields in excess of 4.5%. REITs have historically generated annual returns well in excess of bonds with low correlation to the broader market. While utilities have performed poorly over the past ten years, their downside risk is somewhat limited by public utility commissions. The dividends on utility stocks are taxed today as ordinary income. The tax rate on these dividends may be reduced or eliminated in the near future if President Bush's tax proposal survives without major revision.

There are some things to beware with municipal bond portfolios. Most issues have credit risk that distinguishes them from the full faith and credit of the US government extended to treasury securities. Like any other bond, municipals must offer higher yields to compensate for credit risk. A more appropriate apples-to-apples comparison of yields would contrast treasury securities with AAA-rated tax-exempt bonds. While most issuers of municipal bonds do not enjoy a AAA credit rating, it is quite common for them to include credit enhancement through insurance. Over half of the new issues priced in 2000 were brought to the market with some type of credit enhancement. The benefit to investors is that the insurers will accept the risk in the event of default.

Another key area of misunderstanding is current yield. It applies to all classes of bonds these days but is an especially misleading measure of return with long-term municipal bonds. As rates plummeted over the last two years, municipal bonds started to trade well above face value. Unfortunately, most can be called away by the issuer at or near face value within 7 to 10 years from inception. The economic returns of seasoned bonds are far less than those implied by their current yield. A tax-exempt issue from 1995 trading at 110% of face value today may very well be called away at face value within two years. My recommendation is to rely instead on the *yield-to-call* on each of the bonds in your portfolio to measure the economic value they offer. Or, more simply, avoid individual municipal bonds altogether and instead purchase a mutual fund that passively invests in a portfolio of tax-exempt issues

A more appropriate tool from which to compare yields of different classes of bonds are the benchmark yields on new securities available on most financial websites. CNN's financial website offers timely data at http://money.cnn.com/markets/bondcenter/latest_rates.html . Once bonds become seasoned, they begin trading at significant discounts or premiums to face value. This introduces tax and call option complexities which make it difficult for the average investor to determine a seasoned bond's actual return. The new issue benchmarks offer the clearest picture of the fixed income yield curve.

The takeaway from the foregoing analysis is that municipal bonds can be an important income source for investors without tax shelters. This is true even for Texas residents. At the same time, high grade corporate bonds and some equities with strong yields can provide a solid complement to a portfolio intended for income generation. In today's investment climate, an investor requiring income is best served by more than one class of asset.

"Don't trust the current yield of an individual bond. A bond trading at 110% of face value today may very well be called away at face value within two years"

"Municipal bonds can be an important income source for investors without tax shelters"