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Trust & Investments

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Six Things You Should Know About Investing in Municipal Bonds

Many investors control their tax exposure by adding tax-exempt municipal bonds to the fixed-income portion of their portfolios—especially investors in the highest tax brackets. Is it an option that you should consider today?

1. The muni bond market has been through a rough patch.

Last year \$427 billion in municipal bonds were issued, a record. Then the credit crunch hit. Some companies that insure municipal bonds were downgraded by credit agencies because they also were insuring debt from mortgages granted to people with credit problems. Prices fell, too, when a number of hedge funds had to sell portfolios of high-quality bonds as a result of losses suffered elsewhere. The effect of mismatch of supply and demand was dramatic—in February of 2008, munis dropped 4.2%, their biggest monthly loss in 20 years.

2. Muni yields, relative to other bonds, have recently been at historic highs.

As bond prices fall, their yields increase. Typically, munis trade at about 80% to 85% of Treasury yields, reflecting the fact that interest payments are free from federal income tax. During the first quarter of this year, yields on munis actually exceeded those of similar Treasury bonds, which makes the tax-equivalent comparison even more dramatic.

The muni advantage across the yield curve

Term	Treasury yields*		Muni yields***
	Pre-tax	After-tax**	
Six months	1.40%	0.91%	1.49%
2 years	1.72	1.12	2.15
5 years	2.56	1.66	2.88
10 years	3.48	2.26	3.59
30 years	4.32	2.81	4.40

*Based on sample Treasury yields on 4/14/08; www.bloomberg.com/markets/rates/index.html, Rates and Bonds.

** Assuming marginal federal tax rate of 35%.

***Based on sample yields of AAA-rated bonds on 4/14/08; www.investinginbonds.com, Standard & Poor's Composite Yields Table.

3. Many observers believe the muni default risk is nominal.

Historically, less than 0.25% of munis go into default, according to the Securities Industry and Financial Markets Association. In the event of a prolonged economic downturn, falling property prices and sales tax revenue could challenge state and local budgets—California and Michigan are numbered among them.

4. Different munis bear different risks.

- *General obligation bonds* are issued to raise immediate capital to cover a municipality's expenses and are backed by the taxing power of the issuer, offering a relatively high level of safety.
- *Revenue bonds*, which are issued to fund specific state or local projects, are supported by the income generated by those projects and are considered riskier than general obligation bonds.
- "*Callable*" munis allow the issuer to pay them off prior to maturity, usually when current interest rates drop below the interest rate on the bond. When an issuer calls its bonds, it pays investors the "call" price (usually the face value of the bonds), along with the accrued interest to date and, at that point, stops making interest payments. An investor is then faced with reinvesting the money, perhaps at a lower, less attractive rate.

5. Munis are not entirely tax free.

- *State tax*. Generally, most states do not tax the income from tax-exempt munis but *will* tax the income from out-of-state bonds.
- *Capital gain*. Even though the interest paid is tax exempt, if you sell a muni before maturity at a profit, your gain will be taxable, just as with a taxable bond.
- *Alternative minimum tax (AMT)*. Income from "private activity" municipal bonds will be subject to the AMT, and as such is fully taxable in the hands of taxpayers snared by the AMT. In broad terms, these are muni bonds originally issued after August 7, 1986, whose proceeds are used to benefit a private business.

6. Munis have the same portfolio management issues as taxable bonds.

Given a decision to invest in municipal bonds, should you invest in such bonds directly, or choose the inherent diversification of a muni bond mutual fund? What about creating a *municipal bond ladder*? A ladder consists of a series of bonds, each with a different interest rate and maturity date. As each bond (or "rung" on the ladder) matures, principal is reinvested in a new bond.

Are munis right for you? If so, what is the best way to add them to your portfolio? We would be glad to help you answer those questions.

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