

Surveying the muni bond landscape

Last year was a tumultuous one for municipal bonds. Muni prices tumbled on average 4% in 2008. *The Wall Street Journal* cited a Morningstar finding that ten muni bond funds fell by at least 15% last year. That's happened only four times in the last 25 years.

But the other side of the coin is that muni spreads reached historical highs. Typically, the ratio of muni yields to Treasury bond yields ranges between 80% and 85%, reflecting the fact that the income from munis is free from federal income tax. Ratios ran well over 100% during 2008. And, in December, a ten-year, triple-A muni soared to 186.1% of a ten-year Treasury.

A look at the current scene

Of late, munis have rebounded. In early 2009 bond prices jumped, in some cases back to par value or a bit higher. Yields returned to earth. Yet, as can be seen from the table below, as of February 16 composite yields on triple-A munis were still higher than Treasuries across the yield curve. Is the time fast approaching when munis won't seem the bargain that they have been recently? Prognosticators fall on both sides of the fence.

Treasuries and munis across the yield curve

Term	Treasury yields* Pre-tax	After-tax**	Muni yields***
Six months	0.000%	0.00%	0.46%
2 years	0.875	0.57	1.20
5 years	1.750	1.14	1.80
10 years	2.750	1.79	2.87
30 years	3.500	2.28	4.71

*Based on sample Treasury yields on 2/16/09; www.bloomberg.com/markets/rates/index.html, U.S Treasuries Table.

** Assuming marginal federal tax rate of 35%.

***Based on sample yields of AAA-rated bonds on 2/16/09 in Standard & Poor's Composite Yield Table.

Rocky terrain

There's another question that many investors are asking: Are munis still a "safe" investment? For many states, budget crunches have reached alarming proportions. That signals two concerns for muni bondholders. One, will the municipality make the required interest payments (and make them regularly), and two, will bondholders receive their principal when the bond matures?

Concerns about defaults are only natural when we hear about the possibility of "financial Armageddon" in California and local municipalities declaring that they are close to bankruptcy. According to Standard & Poor's, only 0.15% of investment-grade bonds defaulted between 1986 and 2008. But investors who were around in the 1970s are likely to remember some of the high-profile defaults: New York City, Cleveland, and the largest default in the history of the municipal bond market—that of the Washington Public Power Supply System.

Seeking the safest terrain

Investors looking for maximum safety should consider first general obligation bonds that are issued by states, cities and school districts. General obligation bonds are used to raise immediate capital to cover a municipality's expenses, and the issuer can raise taxes at any time to service the debt. By contrast, revenue bonds, are issued to fund specific state or local projects and are supported only by the income generated by those projects.

What about insured munis? With the collapse and subsequent lower ratings of bond insurance companies, the perception seems to be that insurance adds little to the value of a muni. Prerefunded munis offer an added degree of safety. These bonds are created when municipalities issue new debt to refinance munis issued when interest rates were higher. The issuer uses the proceeds from the refinancing to purchase U.S. Treasuries and places them in an escrow account. These proceeds then are used to pay interest and principal on the original debt until the bond is called. A prerefunded muni is considered almost as safe as a Treasury bond. Somewhat surprisingly, recent yields on prerefunded munis have been almost, or as much as, triple-A munis.

Four tax "notes"

- *State tax.* Generally, most states do not tax the income from in-state 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 Treasury or corporate bond.
- *Alternative minimum tax (AMT).* Income from private activity municipal bonds has been considered a "tax preference" item for purposes of the AMT. (In broad terms, these are munis originally issued after August 7, 1986, the proceeds of which are used to benefit a private business.) For those who pay the AMT, then, the income has been fully taxable. The recently enacted stimulus legislation suspends this rule for private activity munis issued in 2009 and 2010.

- *Tax increases.* Should income tax rates increase as many expect that they will, muni prices will rise, driving yields down as high-income taxpayers are drawn to the tax-free income that munis offer. At the same time, bondholders would be able to sell their munis at a premium.

Adding munis to your portfolio

If you decide to invest in municipal bonds, should it be individual bonds or through a bond fund? The latter provides automatic diversification but carries other risks that you will need to consider. Is the solution 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.

Of course, the best choice for you requires a thorough understanding of your goals and needs and will depend upon your age, tax bracket and other factors. We welcome the opportunity to explore further whether now is the right time for you to add or expand the municipal bond portion of your portfolio. Please contact us at any time.

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MAIN OFFICE:

205 N. Main Street, Suite 101
Bloomington, IL 61701
309.821.1155 / 888.897.2276 toll free
www.hbtbank.com