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Lynn's Top Five LET'S TALK MUNIS (and we don't mean the buses!)

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Retirees and working investors alike are bemoaning the interest income they are earning (or should we say NOT earning) on their income oriented investments. With the recent Fed meeting just behind us calling for no interest rate hikes the rest of the year, this will continue to be true for the foreseeable future as we work our way through the government's plan for economic stimulus and recovery.
One bright spot has been the ability to earn a very decent after tax rate of return on a thoughtfully designed "Muni" Bond (Municipal Bond) laddered portfolio. To say that we could write an entire textbook on the intricacies of Muni Bonds is quite an understatement. Since this is a column and not a textbook, (and here's where you are breathing a huge sigh of relief!) let's just focus on a few key points to consider before you begin adding them to your investment mix.
1) What are they: They are bonds issued by your state, local cities, counties and related municipalities, to raise money for projects. Typically each bond has a different reason for its existence, such as a bond that might be issued by a school district to improve its programs, or a bond that might be issued by a municipality to improve its water treatment plant. Each bond will have a coupon rate that is consistent with what the market will bear when that bond is issued. Maturities are often long-term, and interest is typically paid semi-annually (some only pay upon maturity). Many are non-callable, but be careful because a lot are also issued with an early call provision (meaning that the issuer requires you to redeem the bond prior to the stated maturity date). This allows the municipality to retire the bond early, sometimes at a premium but often at face value, or what is called "par." One of the risks to the bond owner is, if interest rates go down and the bond gets called, he or she may not be able to buy another bond at a comparable rate.
2) How can I buy them: Typically you buy Munis through your investment advisor or broker. Most often your advisor buys them in the secondary market. You can buy them in small or large quantities, depending on your purchasing power and your need for diversification. Another popular way to buy Munis is through a mutual fund. In a bond portfolio of your own individual holdings you can control the exact content, maturity dates, income and ultimately the maturity value of your portfolio. In a mutual fund you cannot, and your asset value will swing as interest rates rise and fall. However, the diversification offered through a mutual fund is hard to replicate outside a fund, not to mention avoiding the job of buying and monitoring the bonds yourself!
3) Laddering: Many investors don't want all of their fixed income assets maturing at the same time. Picking

maturity dates that reflect future personal needs or anticipated interest rate increases (or decreases) is a wise approach. For example, one investor with $100,000 allocated to Muni bonds, might want the diversification of 4 bonds with a $25,000 face value on each bond. Since they might be thinking of using that for their daughter's college education (let's say she starts school in 10 years), they might want one bond maturing in 10 years, another in 11, etc. Upon maturity of the bonds, you can choose to reinvest the proceeds into a new bond. The risk, however, is that there may not be bonds available that offer a comparable rate of return.

4) Safety: Many Muni bonds, especially those that are GO (general obligation) are considered to be among the highest grade (quality) fixed income investments available, aside from US Treasury bills and notes. US Treasury bills, notes and bonds are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value. Some Muni bonds are backed by policies written through insurance companies. The cost of this insurance will take a bit away from the yield, but might provide you with some important peace of mind and a back stop for loss of principal (but not interest) in the event of a Muni bond default (though very rare). Insurance only guarantees timely payment of principal and interest and does not eliminate market risk. Bonds are rated by independent agencies so you can have another sense of their credit worthiness. Of course none of these are absolute guarantees.

5) After Tax Rate of Return: Most investors who buy Munis are interested in them because of the tax free income stream. These are investors who are typically in a fairly high combined state and federal income tax bracket. In this abnormally low interest rate environment a lot of investors in lower brackets are buying them, too, since they have recently been earning more than other types of fixed income investments. These investors need to be aware that when credit markets (and therefore interest rates) return to periods of normalcy, they may regret having locked in these lower rates of return for long periods of time. Although Munis can be sold daily in the secondary market, you still need to find a buyer and you can only sell them for their relative worth (based on maturity, safety and coupon rate) which may not be as much as what they were purchased for. Additionally, income from Muni bonds may be subject to alternative minimum tax.

For the right portfolio, when thoughtfully and carefully purchased, Muni bonds can offer an attractive tax- free income stream. If you aren't familiar with them yourself but would like to consider Muni bonds for your own portfolio, a trusted advisor can be invaluable.

On a different note, I've really appreciated your feedback about these columns. As I run into many of you around the community, you tell me that the focus on investments in these volatile economic times has been helpful. I'll devote a couple of additional columns to investments, and then there are some interesting estate and income tax planning issues we should chat about as well. Please let me know if there are other topics you'd like covered.

Looking forward to seeing you around town!

Reach the reporter at: info@lamorindaweekly.com