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Municipal Bonds – A Primer

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Municipal Bonds (Muni's) are interesting securities and can be excellent investments under many circumstances. This article will get you started determining if Munis fit in your portfolio.

When you have examined your assets and determined how to allocate them between stocks and bonds, you next have to choose what to buy in each category. With bonds, you need to decide to buy tax-free Municipals or taxable bonds such as U.S. Treasury and corporate bonds; or a combination of both.

Let's start by getting a few terms straight. Municipal Bonds are sold by cities and states to raise money for highways, schools and other projects. They are tax-free at the Federal level because the Constitution restricts the Federal Government's ability to interfere with the States' right to raise money. However, Municipals are taxed at the state and local level outside of the local where they are issued. For instance, if a New York City resident owned a NYC municipal bond it would not be taxed by New York City or State. However, the same bond owned by a Norwalk, Connecticut resident would be taxed by Connecticut.

An investor's decision to buy taxable or tax-free bonds should depend upon which offers the highest after-tax return at any given maturity and credit quality. To determine this, expected returns need to be compared on either a pre-tax or an after-tax basis. Since the coupon of a Municipal Bond is essentially what investors receive after-tax and the coupon of a taxable bond is pre-tax; one of them has to be adjusted in order to make a meaningful comparison. The key is for investors to make sure they compare apples with apples – pretax to pretax or after-tax to after-tax. I personally find using after-tax returns more convenient.

Here's an example. "Municipal Bond F's" tax-free coupon is 3.75% which means its after-tax coupon is also 3.75%.

Turning to a taxable bond, we need to adjust its coupon from a pre-tax number to an after-tax one, which is relatively easy. If your tax rate is 20% how much of your income do you keep? 80%. Use the same technique on a taxable bond's coupon.

If "Taxable Bond T" pays a coupon of 5%, and your tax rate is 20%, how much is the coupon worth after-tax? Since you keep only 80%, the coupon of 5% is worth 4% after taxes. In this case, for investors with a 20% tax rate the "Taxable Bond T" has a higher after-tax return (4%) compared to "Municipal Bond F's" (3.75%).

What happens if your tax rate jumps to 30%? The taxable bond's after-tax return will drop to 70% of the 5% coupon or 3.5%. Now "Municipal Bond F" with its 3.75% rate is more attractive than "Taxable Bond T" at 3.5%.

The bottom line is that your current and future tax rates are key to deciding if Municipals or taxable bonds are your best bet.

Many investors smartly hold their fixed income assets in tax-qualified accounts such as 401(k)s or IRAs. In these accounts all bond coupons are effectively after-tax, so taxable bonds will almost always be better investments. Generating tax-free income within these accounts has no benefit. When money is eventually withdrawn it will be taxed as ordinary income.

The Municipal Market

For individual investors, the municipal bond market is very difficult to navigate. Among the major problems are:

1. The large number of bonds available
2. Large denominations of individual bonds
3. Wide Bid/Ask dealing spreads

The large number of bonds makes it extremely difficult for individuals to keep up to date. Just our city of Norwalk has 4 different kinds of municipal bonds backing projects ranging from The Maritime Center to water pollution projects. It is easy to see that since every city and town has multiple projects, the number of unique bonds is enormous.

The next problem is the large denomination or face amount of Munis. Many of these bonds only trade in increments of \$10,000. This can be a major problem for investors trying to build a diversified portfolio. To hold just 10 different issuers at \$10,000 a piece requires a \$100,000 investment.

Investors' most serious issue is the wide Bid/Ask dealing spreads they encounter. Small trades of \$25,000 will often have bid/ask spreads of 3% or 4%. Even trades of \$100,000 are likely to see spreads of 1% or more. At these spreads, moving from one bond to another can cost a full year's interest.

Putting this altogether, I strongly recommend investors use mutual funds like the municipal bond index funds sold by Vanguard for Municipal Bond investments.

To sum up Municipal Bonds should not automatically be included or excluded from any portfolio. Each investor needs to use their own tax rates and compare alternative investments on an after-tax basis.

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