Hartford Business Journal

March 12, 2012

http://www.hartfordbusiness.com/news22998.html?Type=search

TALKING POINTS

Municipal bonds still good fit in portfolio

By Valerie Dugan

Individuals are the single largest group of owners of municipal bonds. Why? Because municipal bonds generally offer investors tax-exemptions, predictable income and typically greater security than corporate equities.

However, with near daily news reports of municipalities — and even states — facing

Valerie Dugan

severe financial constraints, and some even hinting at potential bankruptcy, are municipal bonds still worth consideration?

Absolutely. But there are caveats. These bonds are tax-exempt fixed income securities that represent the debt obligations of municipal entities (states, cities, counties, etc.) seeking to fund projects for the public good, such as schools, highways, and hospitals. The issuer promises to fully repay principal at the bond's maturity along with semiannual interest income — income generally exempt from federal income tax.

One of the most compelling reasons to own municipal bonds is the tax exemption.

Under most state laws, interest income from 'home-state' municipal bonds also is exempt from state and local taxes. As a result, municipal bonds may generate higher after-tax yields than taxable bonds of similar quality and maturity.

So what's the problem? Uncertainty related to the municipality's ability to pay. While the worst of the credit pressures appear to have passed, it remains advisable to consider investing only in high-quality municipal bonds, that is, bonds rated "A" or better by the various agencies that study municipalities and evaluate their creditworthiness. It is important to obtain the underlying credit rating of the issuer to consider in addition to any insurer that may be providing credit enhancement to the bonds.

What that means is that despite Moody's recent downgrade of Connecticut's general obligation bonds from Aa2 to Aa3, these bonds remain "investment grade." It should be no surprise that the rating agency reflected what we see in Connecticut newspapers on a regular basis: the state is in a tough time financially. Any increased financial difficulty can have a corresponding impact on the risk of a municipality's or state's bonds.

Regardless of the state, it always is a good idea to do some research. For bonds of agencies outside Connecticut, it can't hurt, for example, to check the Internet for news accounts of the particular municipality's financial status. Recent news accounts of severe financial struggles should be a clear "red flag." As with most investment matters, of course, the advice of a knowledgeable financial advisor can be critical to monitoring this market.

Buyers can also capture value by extending maturities along the currently steep yield curve, with a good target range now running from six to 14 years.

Municipal bonds are here to stay — as long as the tax exemptions remain. And there is no sign, even on the distant horizon, to suggest this may change.

All fixed income securities are susceptible to interest rates fluctuations. If interest rates fall, bond prices tend to rise and, inversely, if interest rates rise, bond prices fall. Because bonds are typically issued at prevailing market yields, rising market interest rates cause new issues to have higher yields than existing bonds, forcing down prices on existing bonds.

Generally, longer term bonds are more sensitive to interest rate changes, and the more likely their value is to fluctuate. However, longer-term bonds generally have higher yields, thus compensating for the time principal is exposed to interest rate fluctuations. Conversely, bonds with short-term maturities (up to a year) normally experience relatively minimal changes in price as interest rates fluctuate, but also typically provide lower yields.

Another point to consider: if a bond is held to maturity, the principal will be returned in full, yet, if the bonds are sold prior to maturity, the price received may be more or less than the original purchase price.

A family's federal tax bracket plays an important role in determining whether a taxable or tax-exempt security is the right choice. As a general guideline, the higher the tax bracket, the greater the potential benefit from owning municipal bonds.

Nonetheless, it is crucial to do more than just compare yields.

Many municipal bonds allow the issuer to redeem them prior to maturity. If a bond is called, you bear the risk of reinvesting the proceeds at a lower rate of return, impacting your ability to plan your future income stream.

In addition to generating tax-exempt income, the municipal market is attractive in terms of investment quality, maturity, sector focus, and geographical diversity. Municipal bonds could be an important diversification and tax planning tool within your fixed income portfolio.

Valerie Dugan is a financial advisor with the global wealth management division of Morgan Stanley Smith Barney in Hartford.