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Buying Extra Safety In Municipal Bonds

Investors who want safe and steady tax-advantage income usually look to the world of municipal bonds. As of year end 2000, the bonds issued by states, counties, municipalities and other local government entities totaled more than $1.4 trillion. Because the income from these investments is generally free from federal income tax - and usually free of other taxes to residents of the state where the bonds are issued - municipal bonds form the cornerstone of millions of American investment portfolios. However, income from the bonds may be subject to the federal Alternative Minimum Tax (AMT) in some cases and while the interest income is tax-free, capital gains, if any, are subject to taxes.

But how safe are municipal bonds? And how can an ordinary investor be protected from those municipal bond issuers whose finances go awry?

In reality, municipal bonds are usually extremely safe; the government entities that fail to meet their payments are few and far between. However, the occasional instances when government entities have gotten into serious financial trouble - such as Orange County, California in 1994 - underscore the fact that municipal bond investors can take extra steps to help ensure that their investments are secure. One such step is to diversify. Another is to look for bonds that come insured or with credit enhancements. The ultra-cautious investor may even look for both.

Diversification

For small investors, one of the easiest ways to diversify is to invest through a tax-advantaged mutual fund or unit investment trust. Well-run mutual funds and unit investment trusts allocate their investments over a wide range of municipal bond issuers and many also diversify their holdings geographically. Larger investors can accomplish similar diversity by investing in individual municipal bonds issued by many different municipalities.

In-State or Out-Of-State?

One question to consider is whether to invest in bonds issued by municipalities located within your state of residence or to invest nationally. Most states have state income taxes which typically apply to the interest payments received on bonds issued by out-of-state municipalities. Of course, such state income taxes would reduce the return to an investor so many choose to invest only in bonds issued from within their state of residence. An investor should weigh the benefits of added diversity from a national portfolio with the possible additional tax benefits of investing in-state. Consult your financial advisor before making any specific tax-related decisions.

Insured Bonds

Another way to bring an extra level of security to a municipal bond portfolio is to buy bonds that carry the stamp of approval of big municipal bond insurers like AMBAC Indemnity Corp., Financial Guaranty Insurance Co. (FGIC) or Municipal Bond Investors Assurance Corp. (MBIA). Not surprisingly, since defaults on municipal bond payments are rare, the cost of buying insured bonds is little more than that of uninsured munis. Insurance is available on tax-exempt mutual funds and unit investment trusts as well as on individual municipal bonds. Since municipal bond funds and unit investment trusts offer diversity to start out with, many experts believe you do not need the added feature of insurance when purchasing a fund or trust. However, keep in mind that while insurance guarantees the timely payment of interest and principal, it does not guarantee a municipal bond's price in the secondary market. As with any other security, the actual bid price is determined by the market at the time of resale. Bonds sold prior to maturity may be worth more or less than their original cost.

Other Credit Enhancements

While many bonds do not have the backing of a large insurer to give investors an added comfort level, nearly half of all newly issued municipal bonds do come with insurance. Many more of the municipal bonds in the secondary market have been pre-refunded, which means that funds (usually US Treasury bonds or cash) are held in escrow to pay their interest and principal.

Individual Bonds, Funds or UITs?

If you have a large sum to invest in the tax-advantaged market, you can create a balanced portfolio of issues from a variety of government issuers. If you have a small sum to invest in tax-exempt bonds, consider a tax-advantaged mutual fund or unit investment trust. A fund or trust can provide you with a level of diversification for even a small investment. If you do invest in individual municipal bonds, get the advice of someone who can help you choose bonds that are compatible with your objectives and risk tolerance.

It May Not Mean Everything, But Check The Ratings

The large rating agencies, Moody's and Standard & Poor's, try to assess the riskiness of municipal bond offerings. Their analysts assess a number of factors, after which they assign a letter rating to each bond. Under the Moody's system, issues that may be suitable for purchase by conservative investors are rated from high to low as Aaa, Aa, A and Baa. S&P rates this same category as AAA, AA, A and BBB. But the agencies these days have to check more risks than in the past and many more issues. As a result, learning what the rating agencies have to say is not, in itself, enough to assess the quality of a municipal bond. But it is a good place to start.

Dan has over 15 years experience in the financial services industry. He is currently Vice President of Investments and Associate Branch Manager with Prudential Securities. He works and has clients in Dade, Broward and Palm Beach Counties. He lives in Palm Beach with his partner of 18 years, Peter. and their yellow lab, Diva. He can be reached at 800-321-0013.