

By Stan and Hildy Richelson

Investing

Are Municipal Bonds Still a Good Buy?

After the crash of 2008, investors did what they always do: sell stocks and other assets and buy bonds. Bloomberg and the Investment Company Institute reported that from June 2008 through June 2010, investors shifted a net \$480.2 billion into bond funds. (For a point of comparison, \$496.9 billion poured into stocks during the two-year tech stock bubble of 1999-2000.)

Demand for municipal bonds has been high, despite warnings about the budgetary problems that many issuers are facing. During 2009 and 2010, strong demand led to rising prices of high-quality municipal bonds and corresponding falling yields. The situation continued even into the second

half of 2010, as yields on these high-quality tax-exempt bonds illustrate: Scarsdale Unified School District, NY, due on June 1, 2014, had a yield of 0.9 percent; Vermont State General Obligations, due on March 1, 2016, had a yield of 1.43 percent; and State of Delaware, due on Jan. 1, 2020, had a yield of 2.1 percent.

Several other factors contributed to the low yields. First, many issuers chose to issue tax-exempt bonds in the shorter maturities, while taxable municipal bonds called Build America Bonds (BABs) substituted for tax-exempt munis in many issues for bonds with maturities of 15 years and longer. Also, supply for retail buyers of tax-exempt bonds was further

diminished by rule changes that enabled banks to purchase more municipal bonds without negative tax consequences. It should be noted that these two policies are set to expire at the end of 2010 (though extensions could be granted).

Regardless, as 2010 neared its conclusion, withdrawals from municipal bond funds picked up, reflecting a belief by many investment professionals that it was time to get out of bonds. The experts said that yields were poor and the risk of default was rising, as states face flat revenue, rising needs, and huge pension and healthcare expenses for employees and retirees.

While we acknowledge recent developments, we see a stronger picture for municipalities and the bonds they issue. In our opinion, demand for tax-exempt municipal bonds will only strengthen in the next several years. As advisors consider how their clients can best utilize bonds, we believe that the following considerations deserve significant attention: U.S. monetary policy, the failure rate for municipal debt, future tax legislation, ratings on municipal bonds, and the impact of pre-refunded bonds. Let's consider those issues one at a time.

Quantitative Easing by the Fed

In November 2010, the Fed announced a second Quantitative Easing program (QE2) to pump more money into the market to stimulate the economy, create jobs, and reduce interest rates. However, the announcement of QE2 resulted in the sudden increase in Treasury yields and corresponding price declines of outstanding Treasury bonds. The biggest declines have been in the belly of the yield curve between five and 10 years. For example, the yield on the 10-year Treasury note increased from 2.33 percent on Oct. 8, 2010, to 3.29 percent on Dec. 14, 2010. Rather than seeing this as a problem, we suggest that it will allow individuals to reinvest cash at higher interest rates, thus giving them a net overall higher return.

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Default Rates Have Been Low

In a February 2010 report, Moody's stated that the average failure rate for investment-grade municipal debt from 1970 through 2009 was 0.03 percent. Although there were 54 municipal defaults in this period, only three were defaults of general obligation bonds backed by the full faith and credit of the issuers.

Most of the muni default events that have occurred since 2008 involved debt backed by specific revenue streams from failed projects, rather than by a government's default on obligation to

repay investors from taxes. A typical example is bonds for a new Florida housing development that was never completed. One exception is the city of Vallejo, CA, which has been in bankruptcy proceedings for two years. Though other municipalities have stumbled, states have not given permission for bankruptcy proceedings.

As William Selway pointed out in an article on Bloomberg.com in July 2010, states have shown that they will reduce services and raise taxes in order to pay back investors of the more than \$400 billion of state and local debt that is purchased each year for infrastructure, schools, and other needs. Selway added that the Fed's policy of ultra-low interest rates is helping municipalities to service the debt.

From our perspective, the essential problem that local governments face now is not revenue, but spending. For decades, there has been a mutually beneficial partnership between the politicians and the municipal unions—unions negotiate increases in salaries and benefits, and in exchange, politicians get union members' votes and financial support. This partnership is now unraveling, and fiscal restructuring is overdue.

Revenue recovery will not be enough to continue to sustain past spending habits. Pension and health care costs are significantly underfunded in many states, and overall state spending must be reduced. This drama will play out over many years, but the public is coming to understand the problem and to demand solutions.

Federal Taxes Are Rising

Although Congress and President Obama agreed on an extension of federal income tax rates for two years, most analysts believe that federal income taxes will inevitably rise in the future, especially on higher-income earners. They point to one example that was quietly buried in Obama's healthcare legislation that was passed in 2010: a 3.8 percent additional flat tax on investment income for high earners that will begin in 2013.

Municipal bond interest is exempt from this supplemental healthcare tax. For someone in the highest tax bracket, "a yield of 3.8 percent [a pre-tax equivalent rate] would be equal to 5.8 percent this

year, perhaps 6.3 percent next year, and 6.7 percent in 2013, or even more if it is exempt from high state taxes as well," wrote Laura Saunders and Daisy Maxey in *The Wall Street Journal*.

Rating Changes

Until recently, Moody's, Standard and Poor's, and Fitch have used two separate rating systems, one for corporate bonds and another for municipal bonds. Since municipal bonds have historically defaulted less frequently than corporate bonds, state representatives claimed that they were being discriminated against and that their issues should receive higher ratings. Rather than reduce the ratings on corporate and sovereign bonds, which would move many more corporates to junk status, the rating agencies decided to increase the ratings on municipal bonds. Standard and Poor's never adopted the notion of global ratings, but its municipal ratings have drifted higher over time; Fitch and Moody's completed its re-rating in April 2010. The global ratings now reflect the likelihood of default for all types of bonds instead of the "distance to distress" formerly used for municipal bonds.

As a result of re-ratings, bonds that were previously avoided by buyers of high-quality bonds may now be part of the high-quality pool. This might provide a small increase in yields, as the security pool expands within a given rating. As a result of Moody's re-rating, five new states ascended to triple-A ratings: Indiana, Iowa, New Mexico, Tennessee, and Texas. States previously rated Aa1 were raised to stable from negative watch. The biggest beneficiaries were bumped up three grades: California is now rated A1, and Puerto Rico is rated A3. This is a new act for municipal bonds. Previous rating scales will have to be recalibrated to reflect the seismic shift. **NA**

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Handling Pre-Refunded Bonds

With the rise in value of many municipal bonds, our clients have found that some of their high-coupon bonds have been pre-refunded. These are identified on their accounts with a "(p)" placed next to the name of the bond in Fidelity statements. Pre-refunding removes the bonds from an issuer's balance sheet. The maturity date of the bonds becomes the call date.

Pre-refunding replaces the issuer's backing by placing U.S. Treasury or agency bonds of equivalent value into an escrow account. The escrowed funds pay the pre-refunded bond's semi-annual interest payments and the principal on the call date. A pre-refunded bond may be re-rated to reflect the higher quality of the escrowed bonds (although it does not have to be). The shorter maturity and the possible increase in quality of the security backing the bonds may result in an increase in the bond's value.

For example, on Oct. 23, 2008, we purchased on behalf of our clients \$50,000 Harris County, TX, bonds with a 5.625 percent coupon due Oct. 1, 2022. In March 2010, the bonds were pre-refunded. The original cost of the bonds was \$49,945, and the value on April 16 was \$60,351, a difference of \$10,406. Though some of the appreciation was the result of an increase in bond prices generally, the big boost was the pre-refunding. We told clients that if they enjoyed a substantial appreciation, they should consider selling the bond and taking the gain.

-- Stan and Hildy Richelson