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SMARTMONEY MAGAZINE by Elizabeth O'Brien (Author Archive)
Published July 13, 2009 | A A A

8% Returns: The Bond Deals You're Missing

IN THE WORLD OF INVESTING, they went from being a positively boring option to an almost sexy one in a matter of weeks. [Municipal bonds](#), those securities your mom and dad would own and lecture you to buy, toiled in obscurity for decades until the crash made them an almost exciting option for anyone looking for a safe haven. And they remain attractive in today's more encouraging, if still shaky, investment climate as a low-risk product people can own while they're slowly getting back into stocks.

Except for one problem: [Investors](#) across the country are discovering that muni bonds -- which can still deliver an aftertax yield as high as 8% in some income brackets -- have become more popular, as well as a lot more complicated and frustrating. Almost overnight it has become nearly impossible for individual investors to get their hands on many top-quality municipal [bonds](#). Even when they can, they're paying higher prices, and many of the bonds no longer have insurance to protect them from a default by the city or town that issued them. And with a new government bond program that favors large institutions, some buyers are feeling the pinch. "It's a market for the other guy, not for us. It makes me feel small," says Delia Fernandez, a financial adviser in Los Alamitos, Calif., who has \$20 million under management.

Like many far-reaching changes in the world of investing, the shift in the \$2.7 trillion [municipal-bond market](#) has its roots in the financial meltdown. Financial planners and bond traders say the combination of the credit crisis and fallout from the government's new bond program has put a big dent in the availability of many high-quality municipal bonds, just as recession-weary investors are fretting about the health of muni-bond issuers. Even as the credit crisis eases, its impact on the muni market continues to reverberate. Several major muni-bond broker-dealers went belly-up in 2008, making it tougher for ordinary investors to buy or sell bonds. But one of the biggest roadblocks has been erected by Uncle Sam himself. The government's "Build America Bonds" program offers states and towns huge incentives to borrow money-but the bonds are hard for individuals to buy and, worse, come without the tax breaks long associated with ordinary [muni bonds](#). The result is that institutions are snapping them up, but mom-and-pop investors looking for tax-free income are out of luck.

Of course, thousands of tax-free muni bonds are bought and sold each day, and investors with well-connected brokers and advisers can still get many of the ones they want-provided they have the required account minimums of several hundred thousand dollars. But for others, the irony in all the changes is that individual investors have long been the backbone of the market, buying some 70 percent of the bonds themselves or through mutual funds. The new problems are all the more galling, some say, because it was these same small investors who helped save the municipal-bond market from a total meltdown last fall. When institutions and hedge funds were flooding the market with muni bonds in a desperate attempt to raise cash, ordinary investors filled the void and bought much of the highest quality debt, says Robert Lamb, professor at New York University's Stern School of Business. Now, as investors try to rebuild their nest eggs, one of their best tools is becoming one of the most difficult to get.

The Municipal Bond - The Friend of the Little Investor

State and local governments have sold municipal bonds ever since New York City kicked things off with a canal bond in 1812. Three decades later the municipal-bond market had grown to \$25 million. But it really took off after World War II, as governments sought ways to build new projects and individuals clamored for tax breaks. The idea is simple:

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| Index | Price | Chg. | % Chg. |
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| Nasdaq | 2307.90 | ▲ | 25.59 1.12% |
| S&P 500 | 1145.68 | ▲ | 9.46 0.83% |
| Russell 2000 | 643.56 | ▲ | 8.06 1.27% |
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| DJ Total Market Index | 11819.24 | ▲ | 102.86 0.88% |
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Investors who buy bonds are lending cash, for anywhere from one to 30 years, to their local government to build schools, sewers or other big-ticket projects. In return, investors get bonds with a nearly spotless credit history, plus interest payments free from federal income taxes (and state taxes if they live in the state that issued the bond). The higher the investor's tax bracket, the more appealing the bonds become. Because of that tax advantage, municipal bonds historically have offered much lower yields than a corresponding Treasury bond. But today that gap has narrowed, making muni bonds an even better buy. Munis can offer an after-tax yield of about 8 percent. For high-income investors, they could look better still if the top tax rate rises as expected in 2011.

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Are Muni Bonds Financial Narcotics ?

There is growing acknowledgment amongst some muni bond analysts that downgrade risk has increased substantially and therefore significant investor risk of mark to market devaluation may occur. Investors should forget about liquidity when their municipal bond issue goes downhill....unless they are prepared to take a big capital loss

It is astonishing that muni investors are 'blocked' about downgrade risk. Some think of munis as commodities like U.S. Treasuries, but they are not.. A municipal bond is a loan to a municipality or agency which have about as much liquidity as a commercial loan. This is troubling and the way the muni complex works is no different than any other structured or derivative product: no transparency. I see investors ignoring the significance of rapidly declining municipalities' tax receipts, the Federal intervention of propping municipalities up with new fangled inventions (Buy America Bonds) ...(Read more of this comment)

Posted by: DKP50

Posted: 7:23 PM EST July 13, 2009

Muni's? Well Maybe.. but I'm not interested.. Not while I can earn 8-12% apy on Global an Emerging Market Bond funds.. And the Muni's in alot of states are in such Dire Straights? Paying them with IOU's will be next....

Giving \$ to the Politicians to Build Schools? Sure, while they Circumvent it out the back door for everyother Pork Project or who knows what..

Just like the Lotto's were supposed to be used for Schools/education, etc..

and the Insurance on them? Only insures the Principal, not the Interest..

No thanks, I'll pass..

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Why bother with individual [bonds](#) when you can buy a mutual fund? The reasons are both practical and emotional. Although investors in municipal-bond funds also enjoy tax-free interest, they pay capital gains taxes on bonds the managers sell for a profit. And because fund managers spread the money around many different issues, [bond funds](#) never mature. Plus, owning the bond itself gives some investors a sense of pride; they know their money is being used to improve their local schools and roads. Don Barnett, 85, has been buying munis for decades. The retired engineer tries to stick with issues from his home state of Utah. Like other investors he collects the tax-free interest until the bond matures and he gets the original investment back. For Ginger Hatfield, buying individual bonds is something of a family tradition. The 47-year-old software developer from Laguna Beach, Calif., says her father, a bank cashier, found them safer than investing in stocks and urged her to follow in his footsteps.

Now the industry known for being friendly to ordinary investors seems to be stacking the deck against them. It all started, financial planners say, with the financial crisis. Lehman Brothers and Bear Stearns were major players in the muni-bond market, acting as brokers between buyers and sellers of the debt, often holding on to the bonds themselves until they could find the right match. With their demise, no major firms have stepped in to pick up the slack in a significant way, making it harder for planners to find an individual [municipal bond](#) for their clients. It has also made it harder to buy and sell the bonds. **Justin Krane, an independent financial adviser in Los Angeles, says it now takes a few hours longer for a dealer to offer him a price for a bond he wants to sell.**

Even bigger problems were brewing in the market for bond insurance. For years big bond insurers like MBIA and AMBAC sold insurance to states and localities, giving their muni bonds a coveted AAA rating. Investors who never heard of, say, the Froedtert & Community Health hospitals in Wisconsin could take comfort that a big bond insurer was backing the bonds. If the issuer defaulted, investors would get their money back. But bond insurers ran into trouble by selling insurance on risky bonds backed by subprime mortgages. When many of those bonds failed, the insurers had to pay out billions in claims, weakening the companies themselves. As the insurers lost their own AAA ratings, they could no longer guarantee top ratings to others, so many municipalities stopped buying insurance. At its peak in 2005, bond insurance covered 57 percent of all municipal-bond issues. Today only 13 percent carry insurance. Insurance could come in handy now, as the recession batters the nation's bond issuers. Bond fund managers and expert investors, including Warren Buffett, warn that the risk of muni defaults, while still low compared with that of corporate bonds, has nonetheless risen.

For many investors in individual bonds, perhaps the biggest kick in the shins comes from the federal government. In February the Obama administration introduced the [Build America Bonds](#) program to help struggling municipalities sell bonds to start projects. Under the program, the feds send the municipality a check for 35 percent of the interest on its bonds. Some states and localities have jumped on the program, selling more than \$14 billion in just the first three months of the program. California issued \$5 billion worth of Build America Bonds last spring, with coupons of around 7 percent. That state treasurer's office estimates the Build America Bonds subsidy will save California as much as \$1.5 billion over the life of the bonds. It's a great deal for the states but not so good for individual investors. That's because unlike with a normal municipal bond, an investor has to pay federal taxes on the interest from Build America Bonds.

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And the new bonds typically offer 25- or 30-year maturities. While institutions such as pension funds or endowments find that attractive, individual investors often prefer the flexibility that comes with shorter maturities.

What's Next?

No one is proclaiming the death of tax-free municipal bonds just yet, but some experts worry about their future. Critics of the Build America Bonds program say that some federal officials have long felt that investors receive too sweet a deal on tax-exempt muni bonds. The Build America Bonds program is set to expire at the end of 2010, but market participants say it's likely to be extended or even made permanent. Philip J. Fischer, head of municipal-bond research at Bank of America-Merrill Lynch, says Build America Bonds could be a way for the Feds to eliminate much of the tax-favored status traditional muni bonds enjoy.

Alan Krueger, the Treasury Department's chief economist and deputy assistant secretary for economic policy, doesn't exactly discourage that kind of thinking. Indeed, he says the Build America Bonds program is an effort to lower subsidies to individual taxpayers while helping municipalities in their time of need. Krueger says the program is a big success for both institutional buyers and government issuers. But what are retail investors supposed to do? Krueger says they can access Build America Bonds through a [mutual fund](#).

Some investors are doing just that. Others are just fed up with the higher prices, lack of insurance and other headaches and avoiding munis entirely. They are turning, in part, to taxable corporate bonds, says Sarah M. Place, chief executive officer of bond dealer Place Trade. That option doesn't offer all the advantages of owning a muni bond directly. Nor does it provide much sense of civic pride. Unfortunately, Place says, investors don't have much choice. For many people, she says, "the trust is just gone."

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