

'Tremendous' opportunity seen in municipal bonds

STATE AND LOCAL GOVERNMENTS' WOES SEND YIELDS HIGHER — ALONG WITH RISKS

By Kathy Kristof
Los Angeles Times

The municipal bond market has had a rough ride in the past six months, but that could mean now is a good time to invest in the sector.

For the second consecutive quarter, fallout from the sub-prime-induced credit crunch sent yields rising on most muni securities, although they didn't jump as high as they did in the first quarter. A major concern remains the financial condition of the insurance firms backing many muni bonds because those insurers are also on the hook for billions of dollars in losses on mortgage bonds.

"We here in muni-land are fraught with several problems," said Marilyn Cohen, president and chief executive of Envision Capital Management in Los Angeles. "There's the whole credit crisis, the fact that the insurance isn't worth the paper it's written on and the possibility of rising interest rates."

That combination spells risk but also the possibility of bigger-than-usual rewards in the form of higher yields.

"There are tremendous opportunities," Cohen said.

Most categories of mutual funds that invest in the obligations of state and local governments were in the black for the second quarter, but only barely. For example, long-term muni funds on average were up 0.8 percent for the period but down 0.8 percent

for the first half of the year. Long-term California muni funds gained 0.9 percent in the latest three months and were down 1.1 percent year to date. High-yield muni funds returned 0.4 percent in the quarter, and were off 2.7 percent for the first half.

The performance reflects the rise of yields during the quarter. Because a bond's yield and its market value move in opposite directions, if you already own muni bonds, you want yields in the muni market to go down, not up. But if you're thinking of getting into the market, a relatively high yield on a bond means it's relatively cheap.

Although muni yields retreated since the second quarter ended Monday, they remain elevated compared with their average level in recent years. And the fact that interest on munis is exempt from federal and often state income tax only increases their attraction.

"If investors are paying any taxes on their investments at all, they should consider municipal bonds at these prices," said Scott Berry, fund analyst at mutual fund tracker Morningstar in Chicago.

Consider California's latest offering of \$1.5 billion in general-obligation bonds, made as yields were peaking late in June. The 30-year securities in the offering yielded 5.3 percent. If you're a California resident who bought those bonds and you're in a combined federal and state tax bracket of 35 percent, your "taxable equivalent" yield on those bonds — the amount you'd have to earn on a taxable investment to get the same af-

ter-tax cash — would be 8.15 percent.

Of course, higher yields also mean higher risk, at least as perceived by the bond market. In addition to the problem of bond insurers, worry that the weak economy will hurt the financial condition of state and local governments, increasing somewhat the low odds of default on the securities.

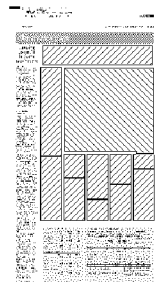
Rising inflation is also a concern. By itself, inflation reduces the lure of most fixed-income investments because their future payments aren't adjusted for price changes. In addition, inflation fears might lead the Federal Reserve to boost its key short-term interest rate, which can lead to higher yields in the overall bond market, reducing the value of existing bonds.

"Usually, munis are boring, and boring is good," said Chris Orndorff, managing principal at Payden & Rygel Investments in Los Angeles. "Right now the market's not so boring."

But Orndorff said the worries were overblown. Most state governments are not so economically threatened that they'd default on their debts. (In fact, California is barred by the state constitution from defaulting on its obligations.) And although inflation is high, the economy is weak, which can restrain price rises and also reduce the chance of aggressive rate hikes by the Fed.

That said, experts advise investors to tread carefully. Their suggestions:

■ Buy bonds with relatively short maturities — in the range of five to 10 years, advises Brent Kessel, co-founder of



Abacus Portfolios in Pacific Palisades and author of "It's Not About the Money." That's because bonds with longer maturities are more vulnerable to a loss of value if interest rates rise.

■ Look for general-obligation bonds, Cohen suggests. Because they are backed by a government's taxing authority, general-obligation bonds carry a significantly lower risk of default than revenue bonds, whose repayment hinges on the tax revenue generated by a particular project.

■ Diversify. Just as it's far riskier to invest in one stock than in a broadly diversified stock portfolio, you're better off diversifying your bond investments. But it can be disproportionately expensive to buy and sell small amounts of bonds, so most experts suggest that smaller investors — those with less than \$200,000 in bonds — invest in bond mutual funds.

■ Pay attention to fund fees. A fund's management expenses eat into the return on your investment. Kessel advises avoiding bond funds with expense ratios exceeding 0.5 percent. A fund's expense ratio will be in its prospectus.

■ Check up on your broker. If you buy individual bonds instead of a bond fund, your broker's commission is invisible — it's built into the price you pay and reduces the yield you get. To know whether you're paying too much, you can look up recent trades at InvestinginBonds.com, Cohen said. Click on "Bond Markets & Prices," then "Municipal Market At-A-Glance." You'll need your bond's CUSIP number. Typically the yield you're getting will be a tenth to a quarter of a percentage point lower than the yields shown on the site. If it's much lower than that, your broker probably is charging too much, Cohen said.

■ Remember taxes. The

tax exemption accounts for much of a municipal bond's value. But there's no tax benefit if you buy muni bonds in a tax-deferred account such as an IRA. And if you're in a low tax bracket or you live in a low-tax state, muni bonds might not be for you. But if you're a high-income taxpayer in a high-tax state and you're investing in a taxable account, it doesn't take much of a return to get a great taxable-equivalent yield.

To calculate your taxable-equivalent yield, subtract your top combined federal and state tax rate from 1, then take the result and divide the bond's yield by that number. For example, if you're in a combined 35 percent tax bracket and you're considering a muni bond with a yield of 5.07 percent, you would subtract 0.35 from 1 to get 0.65. You would then divide 5.07 percent by 0.65 to get a taxable-equivalent yield of 7.8 percent.



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