Investing **locally**

What to know about municipal bonds

By Ed Avis

Note: This is the second of three articles about bonds and the role they play in an investment portfolio. In this installment, we take a look at municipal bonds, often called munis.

When your local government needs to repair a bridge, build a new swimming pool or spruce up its downtown, where does that money comes from? Often municipalities issue bonds, which are essentially loans, to cover those costs.

The municipality "borrows" money from the individual or institutional investors who buy the bonds, pays interest to the investors and eventually repays the principal, using future tax revenue or revenue generated by the project.

"Investing in municipal bonds in one's own community is a great way of giving back to folks in your area," says David Bakke, a personal finance expert at MoneyCrashers.com.

Why do municipalities issue bonds instead of just borrowing money from the bank, as businesses or individuals do? It's because the bonds provide tax-free interest, which means the municipalities can pay a lower interest rate to investors than they would be able to if the interest were taxed.

For example, your city might issue a bond with a "coupon rate" (interest rate) of 2.5 percent. That's pretty low compared to what the city could get if it just borrowed money from the bank.

From the investor's perspective, the low coupon rate may be acceptable because it's tax free (at least federally; it might also be free of state and local taxes, depending on where

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the investor lives). For example, a tax-free 2.5 percent coupon payment would be equivalent to a taxable rate of 3.3 percent for someone in the 24 percent federal tax bracket.

Even 3.3 percent might seem rather low, at least compared to a moderately aggressive stock portfolio. But municipal bonds make steady interest payments, so they're good for cash flow. In addition, bonds sometimes sell for less than their face value, which means the investor is earning an effective yield greater than the coupon payment. Furthermore, munis rarely default.

"Municipal bonds, generally speaking, are rather safe investments—[but] probably not as safe as T bills, which are widely regarded as one of the safest investments out there," Bakke says. "With municipal bonds, you do have some risks, such as interest rate increases and credit quality issues, although that last one can generally be avoided by only investing in higher rated bonds."

If you're interested in buying munis directly from your local government, it is possible to do so. Many municipalities, including Los Angeles and Chicago, maintain websites with information about their bonds. You can even sign up for alerts about new bond issues.

To make the purchase, you need an account at the bank or group of banks that are helping the municipality issue the bond. New issues are usually available just for a few days, and typically come in denominations of $1,000. Buying a bond directly during that window means you will pay the face value.

However, it's simpler to talk to your broker to arrange such a purchase. The broker could also help you buy bonds on the "secondary market," which is where bonds are traded after the initial issue.

It's even easier — and safer — to

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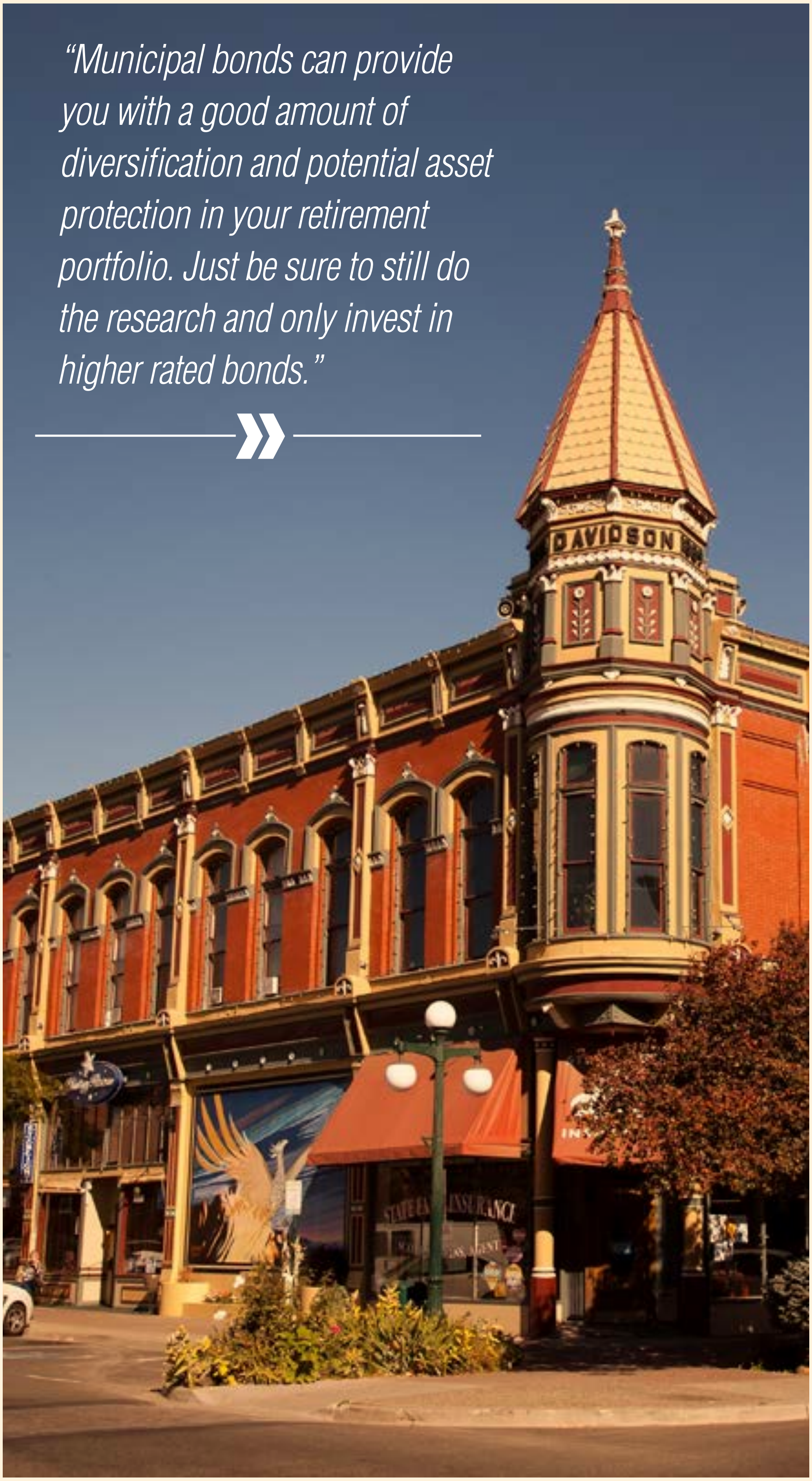
invest in a bond fund that includes munis.

"Years ago, I used to sell a lot of individual bonds," says Mike Piershale, president of Piershale Financial Group in Barrington, Illinois. "But an advantage of buying a bond mutual bond or ETF is that it will have 300 to 400 bonds in it, so the risk is reduced a lot. And the bond ETF trades on the stock exchange, so I can sell it at any time of the day and I know I will get the market value. If you have individual bonds, sometimes you can sell them right away, but I've seen times when they have a thinly traded market and it sits there a couple of days."

Munis are not all created equal. Local governments occasionally, though rarely, default on their bonds. And risk isn't the only challenge with munis: understanding the return, both short and long term, can be complicated.

"The information about bonds is not as fluid as it is in equity markets," says Vincent DiLeva, a senior partner at Signature Estate & Investment Advisors, LLC, an investment advisory firm headquartered in Los Angeles. "We spend a lot of time educating our clients on the different risks, yield-to-maturity, coupon rates, and other details."

Bakke echoes that idea: "Municipal bonds can provide you with a good amount of diversification and potential asset protection in your retirement portfolio. Just be sure to still do the research and only invest in higher rated bonds." ❱



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