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Municipal Bond Tips

Whether you're just investigating municipal bonds or are reviewing your current muni bond portfolio, consider the following guidelines:

✔ **Compare the returns from municipal bonds to other types of bonds.** Since the interest income is exempt from federal, and sometimes state and local, income taxes, your marginal tax bracket is a significant factor in deciding whether municipal bonds are appropriate for you. (Any capital gains are subject to taxes. Interest income for some investors may be subject to the alternative minimum tax.) Make sure to determine how a muni bond's yield compares to the after-tax yield on a comparable taxable bond. To do that, calculate the tax-equivalent yield for the municipal bond. If you're not investing in a municipal bond issued within your resident state, which also exempts income from state and sometimes local income taxes, the calculation is fairly straightforward: the taxable equivalent yield equals the tax-exempt interest percentage divided by one minus your marginal tax bracket.

✔ **Don't simply select the bond maturity that offers the highest return.** Since interest rate changes can significantly affect your bond's market value, it may make more sense to select a maturity that coincides with when you need the principal. If you are investing with a long time horizon, evaluate the yield curve for municipal bonds before deciding on a maturity date. A yield curve is a graph that plots interest rates for the same type of security for a series of maturities, usually from three months to 30

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Invest Automatically

How much did you pay in federal income taxes last year? If you're like most people, you probably only have a vague idea, even though those taxes are taken out of your paycheck every pay period. Because you don't actually write a check to the federal government, you really don't notice how much is being taken out for income taxes.

Learn this valuable lesson from the federal government, and you may increase your chances of achieving your financial goals. Instead of periodically writing a check to your investment account, automatically have a set amount deducted from your paycheck every week that is directed to your investment account. Just let the money accumulate week after week without thinking about it, and in a few years, you'll probably be surprised at how much has accumulated.

Since this is a dollar cost averaging program, be aware that it does not ensure a profit or protect against loss in declining markets. Before starting such a program, consider your financial ability to continue purchases through periods of low price levels. ❍❍❍

Municipal Bond

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years. The normal shape of the curve is upward sloping, since interest rates usually rise as the length of the bond increases. However, at times this relationship can become distorted, causing a flat or inverted curve. You may find that increasing the maturity of your bond by a couple of years will increase your return or that committing your funds for a long time does not bring much additional return in exchange.

✔ **Look at a bond's call provision.** Most municipal bonds come with a call provision, which allows the issuer to redeem the bonds prior to their scheduled maturity. In effect, call provisions allow the issuer to change the maturity date without your approval. Calls are generally only exercised when market interest rates are lower than the interest rate being paid on the bond and are generally not good news for the bondholder. While most municipal bonds have call provisions, the exact provisions can differ significantly among bonds. You can't prevent an issuer from exercising a call provision, but you can use foresight to purchase bonds with call provisions that are most favorable to you.

✔ **Review the bond's credit quality.** While municipal bond defaults are rare, they do occur, so review carefully the credit quality of muni bonds. You may want to stick with investment-grade ratings, which means that the issuer is considered financially stable and unlikely to default. Ratings of BBB or higher from Standard & Poor's and Baa or higher from Moody's are considered investment grade.

✔ **Hold a diversified portfolio.** You should consider holding seven to nine different issues to be diversified, although diversification does not ensure a profit or protect against loss. Be careful not to hold an excessive number of individual issues, which can become an administrative struggle. For each bond owned, you need to ensure that interest payments are received, reinvest the interest income, and monitor credit quality, maturity dates, and call dates.

✔ **Consider bonds issued in your resident state.** Purchasing muni bonds issued in the state in which you reside means that your interest income will also be exempt from state, and sometimes local, income taxes.

✔ **Search until you find a bond that meets your criteria.** With so many different bond issues available, you should be able to find one that meets your particular criteria.

✔ **Review your holdings periodically.** Review the credit ratings of all your municipal bonds at least annually to make sure the quality hasn't deteriorated. Check the call provisions so you aren't surprised by a call in the coming year. Also, review your holdings to see that they are still consistent with your overall investment objectives and asset allocation plan.

If you'd like assistance with your municipal bond portfolio, please call. ❍❍❍

Clean Up Your Portfolio

Now is a good time to gather your information together, thoroughly analyze it, and clean up your portfolio. Some points to consider during this review include:

✔ **Take another look at your asset allocation plan.** Do this before you review your actual investments, so you aren't influenced by your current allocation. You may now realize that your risk tolerance is lower than you originally thought, so some changes to your allocation may be needed. Or you may realize you need to increase your allocation to one investment category or another to reach your financial goals.

✔ **Find your most recent statements.** List each investment and its current value. Total your investments by category — cash, bonds, and stocks. Then compare those percentages to your asset allocation plan. If you haven't done this review in a while, you're likely to find your current allocation is off.

✔ **Decide how to get your allocation back in line.** Look for ways to accomplish this as soon as possible.

✔ **Get rid of small accounts.** It's not unusual to find you have several small accounts. Perhaps you have a bank savings account with several hundred dollars in it that you don't use anymore. Or you may have a small investment account that you received as a gift. The accounts may be so small that you haven't taken the time to cash them out. But you still have to look at the statements every month and make sure any income is included on your tax return. Consolidate the funds in one account.

✔ **Look for ways to simplify your investments.** Do you have a variety of individual retirement accounts (IRAs) that can be consolidated in one IRA? Do you own similar stocks or other investments that aren't adding much in the way of diversification? While you want to be properly diversified, minimize the number of accounts and investments you own so your investments are easier to monitor. ❍❍❍

Invest or Pay Off Debt?

It can be difficult to decide where to allocate your funds when you want to both increase your investment portfolio and reduce your outstanding debt. The decision typically depends on the potential return of the investment compared to the interest rate paid on the debt.

For instance, if you are considering purchasing a bond with a 5% interest rate, paying off a mortgage with a 6% interest rate, or reducing credit card debt with a 12% interest rate, you should probably pay off your credit card debt. When analyzing the situation, look at after-tax, not pretax, rates. In this example, interest income from the corporate bond is subject to federal income taxes, the mortgage interest is tax deductible, and there is no tax deduction for the credit card interest. If you're in the 25% tax bracket, the 5% rate on the corporate bond will net 3.75% after taxes, the 6% mortgage costs 4.5% after taxes, and the 12% credit card debt costs 12% without an income tax deduction.

There are some situations, however, when you should consider other factors, including:

✔ **When your employer matches your 401(k) contributions —** Many employers match contributions to 401(k) plans, which is money you lose if you don't contribute. Those matching contributions can make a big difference when deciding whether to invest or pay off debt. For example, assume your employer matches 50% of contributions up to 6% of your salary. If you're earning $50,000, a 6% contribution equals $3,000, with a $1,500 matching contribution from your employer. Thus, you should typically take advantage of all matching contributions before using money to pay down debt.

✔ **When you are paying down your mortgage rather than other debt —** Often, there is psychological satisfaction in paying down your mortgage to build equity in your home. However, mortgage debt is usually the last debt that should be paid off, since interest rates are typically lower than other forms of debt and the interest payments are tax deductible. If you want to pay down debt, make a list of all your debts, the interest rates, and whether the interest is tax deductible. Start paying off the debt with the highest nondeductible interest rate. Once that debt is paid in full, move to the next highest interest rate.

✔ **When you're using money from your retirement savings to pay off debt —** Many 401(k) plans allow loans at relatively low interest rates. Thus, you may be tempted to take out a loan and use the proceeds to pay off your high-interest-rate credit card debt and auto loans. One of the dangers of this strategy is you'll start to regard your retirement savings as a piggy bank that can be dipped into whenever you need money. It's typically better to leave retirement savings alone so the money can compound for your retirement. Also, you don't want to take out a loan, pay off your credit cards, and then start running up balances on those cards again.

Please call if you'd like to discuss whether to invest or pay off debt. ❍❍❍

Set Your Own Debt Limit

Credit can be a valuable tool that allows you to purchase major items and pay for them over time. But the ready availability of credit also makes it easy to incur more debt than you can comfortably repay. Rather than allowing lenders to set credit limits for you, evaluate your financial situation and determine your own limits.

To find out where you stand with consumer debt, which includes all debt except mortgage debt, make a list of your debts and monthly payments. Then calculate your debt ratio by dividing your monthly debt payments by your monthly net income. The general guideline is that your debt ratio should not exceed 10% to 15% of your net income, with 20% usually considered the absolute maximum. However, you should consider your own circumstances and decide how much debt you are comfortable with.

Before purchasing something on credit, carefully evaluate whether it makes financial sense to do so. Some questions to ask yourself include:

✔ Should I wait and save the money so I can pay cash for the item?

✔ Will the cost of the item increase or decrease in the future?

✔ Is it really worth paying interest on the item so I can use it now?

✔ Will I still be within my designated debt limits if I add this new debt payment?

✔ Will the item still have value after I finish paying for it? ❍❍❍

Separate Your Risk

Your willingness to assume risk with your investments is not necessarily a static concept. You may be less willing to take risk with investments designated for an essential financial goal, while you may be more willing to take risk for nonessential goals. However, those varying risk levels may be difficult to assess if all your investments are commingled in one account.

For instance, assume you have three goals — to ensure you have enough funds to support yourself through retirement, to send your children to Ivy-league colleges, and to purchase a vacation home.

The most crucial goal is to ensure you don't run out of money during retirement. Thus, you want a high level of assurance that you'll reach that goal, devoting a substantial portion of your resources to the pursuit of it. Your investments for that goal are likely to be somewhat conservative, especially as you approach retirement age.

The next important goal is sending your children to Ivy-league colleges. You have more limited resources to devote to that goal, plus your children can attend less-expensive colleges or pay part of the costs themselves. For that goal, you may be willing to assume more risk with your investments to increase the likelihood of reaching that goal.

Your goal for a vacation home is clearly last, so you may have few resources to devote to it. For that goal, you may be willing to use very aggressive investments, since that may be the only way you can achieve that goal.

The point is that your willingness to assume risk is not static. It will vary depending on how important the goal is to you and how much you can designate to that goal.

Commingling all your investments for all goals in one account may make it difficult to analyze your investments in this manner. Thus, you might want to set up separate accounts for each goal, so you can more closely match the investments to your willingness to assume risk for that goal.

Please call if you'd like to discuss this concept in more detail. ❍❍❍

Know When to Sell

When purchasing an investment, write down your reasons for purchasing the investment and when you will sell. That could include both upside and downside sell criteria. As an investment is declining, it is common to come up with excuses to delay selling — it's a temporary setback, wait until next week, wait until earnings are reported, etc. Then, the further the investment declines, the more likely that you will want to wait for the investment to turnaround before selling. That is how large losses are incurred.

Instead, set a firm sell guideline, which will ensure that you don't incur substantial losses. For instance, you might sell an investment when it declines by 10% of your purchase price. While it will probably still be painful to sell the investment at a loss, this will ensure that you don't incur major losses in your portfolio. You have effectively put a cap on your losses.

Please call if you'd like to discuss exit strategies for your investments. ❍❍❍

Financial Thoughts

In a recent survey of retirement plan participants, 55% said that their pensions and retirement savings had declined due to recent events in the economy and the financial markets. However, almost 80% of respondents were confident of having the resources to live comfortably for the first five years of their retirement. That confidence level dropped to 40% when respondents were asked to anticipate 25 years into retirement. Forty-five percent of the respondents were concerned that their employer would reduce benefits (Source: Towers Watson, 2010).

Almost 70% of business owners plan to work until age 65 or older, up 17 percentage points from December 2007 and 28 points from September 2005. Those anticipating retirement by age 60 reduced from 21% in December 2007 to 11% now (Source: Wells Fargo, 2010).

Individual life insurance policy ownership stands at 44%, the lowest level in 50 years. Nearly one-third of Americans (30%) have no group or individual life insurance protection. More than 40% of respondents said they haven't bought life insurance or added additional coverage because they have other financial priorities (Source: LIMRA, 2010). ❍❍❍