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Bad Idea: Buying Munis

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Municipal bonds look really good now. I often get questions from people who want the bonds' tax-free income. My answer: These bonds are a bad deal, and could lose you money.

What I often find is that, when an individual investors "want" something, it is because somebody convinced them that they need it. Usually, that somebody is trying to sell the exact thing. Municipal bonds – the obligations of states, counties and other local entities – are an easy sell, as they provide:

1. Income that is free from federal taxes and from state taxes if you buy munis in your state.

2. Securities that are not as volatile as stocks

In this rocky environment, who wouldn't want an investment that is tax-free and doesn't fluctuate like the stock market? People are scrambling into muni mutual funds: New cash inflows for June totaled $1.3 billion, up 38% from May, according to a report [1] by the Investment Company Institute. Through mid-year, muni issuance surged 69% to $192 billion, according to a Securities Industry and Financial Markets Association compilation. [2]

However, if you examine these issues in more detail, municipal bonds end up not looking that good.

First, let's focus on tax-free income. If I gave you the choice between a taxable bond that pays interest of $100,000 and a bond that generates $100,000 tax-free, which would you want? Easy answer, all things being equal, you choose tax-free.

True, munis typically yield less than other types of bonds, so you have to look at tax equivalent yield (TEY) – what they would pay if they were taxable bonds. So in my example above, let's say I gave you the choice between $100,000 taxable and $70,000 tax-free. To get the TEY, you divide the $70,000 by your tax rate. If you are in a 35% tax bracket, then the $70,000 is the same as $107,000 before taxes are paid. So the muni bond is better, right?

That's what the salesman wants you to believe. But we are still missing the most important issue: How much money do you have in your pocket in the end.

The return from a bond is more than just interest payments. It is also capital appreciation or

depreciation. If I earn $100,000 of interest but lose $500,000 of principal, then I have a net loss of $400,000. When looking at any investment there are three key questions to ask yourself:

1. Can I lose money?

2. If so, how much?

3. Am I being paid enough to take that risk?

As of late last week, the yield on the Merrill Lynch 7-12 year tax-exempt index [3] was 1.65%. Forget about TEY for a minute and think about this: I am being paid 1.65% tax-free to take the following risks:

1. My bonds might go bankrupt. Look at all the localities declaring bankruptcy and the problems that states have with their budgets. Yes, the number of municipal bankruptcies is still low. But in the past month, four California cities filed for insolvency or said they would: Stockton, Mammoth Lakes, Compton and San Bernardino. A recent *Wall Street Journal* article [4] said that there is a new willingness among local officials, hard-pressed by budget woes, to take their towns bankrupt.

2. Interest rates will increase, making my principal go down. They now are very low. Once the economy recovers, they surely will rise. Rates move in the opposite direction from bond prices. After all, who will want a bond paying 1.65% when they can buy one yielding 5%?

These risks are very real possibilities. Is 1.65% tax-free worth it to take these risks? No.

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