

Thinking About Munis? Make Sure You're Making Wise Picks

Municipal bonds have long been a safe haven for higher-income investors looking for safety and greater tax efficiency. The credit squeeze put the municipal bond market through its paces like other competing markets this year, but it may be time to take a second look at both municipal bonds and muni bond funds.

Let's start with a definition of what a municipal bond is. A municipal bond, or muni, is a bond issued by a local government or its agencies to raise funds for a host of reasons tied to keeping the government going. The potential issuers may include cities, counties, redevelopment agencies, water and sewer projects, school districts, publicly owned airports, seaports and other transportation entities. They pay for everything from immediate government expenses to new roads and various public projects. Municipal bonds come in two flavors—general obligation bonds and revenue bonds. General obligation bonds are intended to raise immediate capital to cover government expenses; revenue bonds are the ones that fund infrastructure projects.

As an incentive for investors to buy these bonds, interest income is often exempt from federal income tax as well as the income tax of the state in which they are issued. Mutual funds that invest in municipal bonds also offer the same tax treatment.

This year has held lots of excitement for muni investors and those who were hoping to be. The credit crunch sucker-punched funding sources for public projects as well as private investments. Many municipalities ended up dropping certain projects because investors weren't there to buy the paper and other sources of financing had dried up as well.

Who's fled the muni market? Hedge funds, issuers of structured notes and municipal bond mutual funds trying to keep up with redemptions from tapped-out investors. Right now, the best source of demand for munis is individuals, who can account for only so much business. But in the absence of other buyers, that's potentially good news for you.

Keep in mind that even during the Great Depression, no state defaulted on its general-obligation bonds, and while some munis have defaulted, overall, such defaults are very, very rare.

So where's the opportunity for you? Look at some of the highly rated outstanding bonds. You'll find some amazing yields that you certainly won't find in CDs and other investments. Even though their prices have plunged, some municipals late last year were offering long-term, tax-free yields of five percent and above, which translate into the equivalent of nearly seven percent for taxpayers in the 28 percent bracket and nearly eight percent for someone in the top 35 percent bracket when the tax exemption is considered.

That's a very nice return relative to U.S. Treasuries, considered the safest investments of all.

But before you buy, here are some things to know and steps to follow.

Are munis right for you? The first call you make shouldn't be to a broker. It should be to your tax professional and your financial adviser. A CERTIFIED FINANCIAL PLANNER™ professional can take a look at your entire taxable investment portfolio (there's no point in putting tax-exempt munis into tax-exempt accounts like IRAs or 401(k)s) and determine whether they're the right approach to take for your investments.

What munis are in trouble? There are some governments who issued a hybrid muni known as a variable-rate demand note. These were sold mainly to institutions with maturities of up to 30 years that were paying at rates reset as frequently as once a day. During the crisis, the rates on these notes have shot up to double-digit territory, putting the municipalities that issued them under particular strain due to short-term interest rates that can be reset as frequently as once a day.

Keep an eye peeled for the AMT: While most munis pay interest that's free from federal income taxes, some may pay rates that are subject to the alternative minimum tax, known as the AMT. It's a little more complicated than we have space for here, but this is absolutely why you need to talk to your tax professional or financial planner before making a move into munis.

Don't forget to ladder: "Laddering" is a portfolio structuring term. To ladder bonds means that you are buying them with maturities occurring at regular intervals, so when they mature, you'll have money to reinvest at those same regular intervals.

Watch those ratings: Yes, the main private investment ratings firms—Moody's and Standard & Poor's among them—have been in the doghouse for rating many battered investments highly, not just munis. But most municipals rated AA or AAA are generally safe to consider. It's also important to check the issuer's long-term ratings history. If they've been consistently highly ranked over decades and the municipality has no financial scandal (something that can be checked through news archives on the Internet), that's another good way to research a bond issuer before making a purchase.