

Why Tax-Exempt Municipals are a Smart Investment

Tax-free municipal bonds offer investors the opportunity to achieve enhanced yields and a way to shelter a portion of their income from federal and, in some cases, state income tax. We believe municipal bonds deserve a prominent place in a diversified investment portfolio.

The following is a list of reasons why tax-free municipal bonds should be considered:

SAFETY

- AAA rated tax-free municipal bonds are considered among the safest investments available today. They are considered second only to U.S. Treasury obligations when it comes to safety.
- Municipals, like most debt securities, provide a dependable income stream. In almost all cases the interest rate is fixed for the life of the bond, so investors have a dependable cash flow.
- The default rate on municipal bonds is low compared to other fixed income securities. Historically, the default rate on municipal bond issues has been below 0.1% of the total amount of dollars invested in municipal bonds.
- Because of the safety factor, the original investment is secure, and the face value of the investment will be returned at a specific point in time – the maturity date.

TAX ADVANTAGES

- An investor in the 35% federal tax bracket would need to earn more than 7.50% on a fully taxable bond to match the yield from a 5% tax-free municipal bond. The higher tax bracket an investor falls under, the more attractive tax-exempt income becomes on a tax equivalent yield basis.
- In many cases, interest income received on bonds issued by state or local governments within the holder's state of residence is also exempt from state income tax, increasing a bond's taxable equivalent yield even more.

GROWTH

- A discount municipal bond (priced below par) provides the investor with additional call protection. If the bonds are called, there is an additional capital gains advantage. Municipal bonds trading at a premium (priced above par) offer a more attractive semi-annual cash flow.
- Reinvesting interest income from your tax-free municipal bonds in additional municipal securities allows the portfolio to grow at a compound rate of return, which is exempt from federal and, in some cases, state income taxes.



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- There are also “zero coupon” municipal bonds, which are purchased at a discount and return the full face value at maturity. However, these bonds do not pay semi-annual interest; hence the name “zero coupon.” The difference between the purchase price and the face amount returned at maturity is the “interest” received on the bonds. Zero coupon municipal bonds provide the equivalent of a guaranteed, tax-free reinvestment rate for the life of the bond.

LIQUIDITY

A large secondary market exists. Because the market is so large, nearly \$2.4 trillion outstanding in the fourth quarter of 2006, investors enjoy the advantage of choosing from a wide array of maturity, sector, and credit quality options in building and diversifying their portfolios.

INSURANCE

The guaranty of principal and interest by municipal insurance firms continues to be a major factor in the tax-exempt bond arena. A municipal bond insurance policy is a guarantee by the insurer designed to protect the bondholder from non-payment of scheduled principal, interest or mandatory sinking fund payment. It is important to remember that the individual issuer remains the first source of payment for principal and interest on the bonds and that the insurance will only come into play in the event of non-payment. Unlike other insured securities, CDs for example, with insured municipal bonds, there is no maximum limit on the insurance protection.

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