MARKET MONITOR

ROYAL ASSET MANAGERS, LLC
MAY 2015 VOLUME X ISSUE 1

Owning Municipal Bonds in Retirement: Probably *Not* What Everyone Needs

BY: MICHAEL ALEXENKO, CFA

You've probably recently seen a TV commercial starring an older couple talking about their finances and the lady states something such as, "In our retirement, tax exempt interest is exactly what we need!" The company releasing this commercial along with the company that has issued a commercial message depicting a bald headed annuity broker claiming that none of his investors lost money during the stock market crash should be hit with an immediate Cease and Desist Order from Securities and Exchange Commission.

The TV spot about tax exempt interest is nearly a perfect 180 degrees from the truth. Tax exempt bonds (also known as tax frees, munis, or municipals) make the most sense for investors when they are in a high income bracket and/or when they have significant sums of money in taxable accounts. Both of these conditions are typically opposite for retired persons. In retirement our incomes usually drop from the salary level we earned while employed and, more often than not, a majority of the assets we own are held in tax deferred accounts such as an individual retirement account (IRA).

It is very important to remember that an IRA ***is*** a tax deferred account. That means that you pay ***no*** income taxes on the earnings or capital gains in your IRA. The IRS *does* consider withdrawals or distributions from an IRA to be income producing events, and that is when funds get taxed. However, the taxes paid have nothing to do with the type of assets you own in the IRA. So, assume that the retired couple featured in the advertisement owns $1 million of muni bonds in an IRA, and a client of Royal Asset Managers owns $1 million of taxable bonds in an IRA. Which couple is going to be subject to the higher tax? The answer is that neither will pay taxes on the interest income earned regardless of whether it is tax exempt or taxable because IRAs shelter a person from paying income taxes on the account's earnings. The only time you pay taxes on an IRA is when you withdraw funds from the account.

What I don't like about the television ad is that it's designed to pique curiosity about muni bonds to a vulnerable target market using an angle that offers little benefit to the people it purports to want to help. About the only argument that can be made for muni bond ownership for retired people with ordinary levels of wealth is the safety that they've represented. During 1970-2007 on average only 1.3 annual defaults occurred in the muni market. That number has ticked up to an average of five in the 2008-2013 period according to the bond rating agency *Moody's*. And, a default doesn't mean that you lose 100% of the money invested in the bond. It means that the issuer has failed to meet an obligation but that

$$\textit{Tax Equivalent Yield} = \frac{\textit{Tax Exempt Bond Rate}}{\textit{1 - Income Tax Rate}}$$

Fig. 1: Interest Rate Earned on a Muni Bond

After Tax Yield Comparison		
Federal Income Tax Rate	**Corporate Bond Coupon Rate - 4.25%**	**Tax Exempt Coupon Rate - 3%**
15%	3.61%	3%
25%	3.19%	3%
33%	2.85%	3%
35%	2.76%	3%
40%	2.55%	3%

Fig. 2

See "True Benefit," page 2

Calculating the True Benefit of Municipal Bonds

Continued from Page 1

doesn't cause the entire bond to become worthless. Collection rates on defaulted bonds are surprisingly high. *Moody's* reports that even the worst recent defaults that occurred in Jefferson County, AL and Harrisburg, PA had collection rates of 69%. Detroit's Chapter 9 bankruptcy is still being worked out, but my guess is that it is likely to drag down this average.

Take a close look at this article's embedded charts. These illustrations provide the two major calculations that people need to perform in order to accurately determine whether a muni bond investment offers any benefit to them. In order to entice people to invest in muni bonds the Federal government long ago exempted the interest earned by bondholders from Federal income taxation. That has allowed municipal issuers to reduce the cost of financing their local projects by bringing to market bonds at lower yields than corporations.

The first graphic is a quick calculation that helps you determine what interest rate you earn on a muni bond assuming you had to pay tax on the investment. Say a short term muni bond would pay you 1.1% and a bank was offering a two year special CD for 1.5%. If you know that your tax bracket is 25%, then the bank CD offers the slightly superior investment especially when you consider the FDIC insurance.

Consider the *After Tax Yield* chart; you'll see in this chart that all other things being equal, such as credit rating and bond maturity-unless a person is in the 33% tax bracket, it actually makes little sense for someone to buy the muni instead of the corporate bond given the example's competing interest rates.

More importantly if an investor is comparing the ownership of these bonds to be held in a retirement account, then the corporate bond will earn about 142% of what the muni is offering. So you can see, despite what the lady in the TV ad said, muni bonds could be the exact wrong thing for a retired couple, or any couple, to own in an IRA.

Market Snapshot: Signs May Point to Increased Volatility

By: Michael Alexenko, CFA

It's hard to figure out exactly what keeps pushing the stock market higher, until you reflect on a Federal Reserve's balance sheet that is about six times larger than it was six years ago. The S&P 500 is now trading at 18.3X projected 2015 earnings. A reasonable historical average is about 16X earnings. That means the S&P 500 could very well be trading about 12.5% lower than it is currently and be adequately valued.

What's more alarming about the market's valuation, is that it exists at a time when the performance of the economy has been inconsistent and below average. In 2014, our economy grew at about 2.4% vs. an expectation of 3% and this year the first six months appear to be tracking at a rate of just above 0%. Added to the mix of news that makes investors more risk averse is the action in the bond markets. We started this year with an interest rate of 1.8% on the 10-Year Treasury note and that rate now stands at 2.25%. That's a significant move and has lowered the YTD return on bonds to just above breakeven. The bond market seems to be getting ahead of the Fed rate increases which makes it all that more likely that the Fed may be pressured to hike rates sooner than it prefers. This is the next hurdle for the markets and we should expect stock and bond volatility to rise.