

# MUNICIPAL BOND FUNDS:

## PACKAGED TAX-EXEMPT INCOME

By John Markese

Tax-exempt bond funds have decidedly different strategies, but the end game is always the same—to minimize taxes.

Want a steady income stream but don't want to pay taxes on the income? Don't want to be bothered with buying individual bonds and managing a bond portfolio yourself?

Looking for a simple tax shelter?

This may sound like a come-on for an investment you will soon regret. But as it turns out, municipal bond funds live up to the description. The only difficulty with muni bond funds: Picking one.

### TAX-SHELTERING RETURNS

The purpose of municipal bond funds is to generate income that is exempt from federal, and sometimes state and local, taxes. But not all returns from tax-exempt bond funds are tax-exempt. Some funds generate significant return in the form of capital gains, which is subject to taxes.

Differences in maturity of the bonds held by a fund drive differences in capital gains, returns, income, and risk. In Table 1, statistics are presented for national, investment-grade, tax-exempt bond funds tracked in the *Quarterly Low-Load Mutual Fund Update*.

National funds are funds that do not have a specific state focus. Investment-grade narrows the fund listing down by eliminating high-yield bond funds, which concentrate in lower-rated, higher-default-risk bonds.

Take a look at Table 1 on pages 9 and 10 and you will notice that the funds have been grouped by weighted average maturity—short-, intermediate-, and long-term; within each of these, they are ranked by yield. The short-term maturity category ranges up to three years, intermediate is three to 10 years, and long-term is over 10 years, with the longest maturity fund at a very long-weighted-average portfolio maturity of 24.0 years.

Yield, the focal point for most tax-exempt bond fund investors, is annual income per share relative to ending net asset value per share for the period. Net asset value per share is simply the market value of the portfolio divided by the number of fund shares. Yield is not total return because it does not include any capital gains or losses, but it does indicate the income flow relative to investment value.

The charm of these tax-exempt bond funds is quickly evident when the tax-exempt yields are converted to fully taxable equivalent yields. In other words, the yield on a taxable bond or bond fund that would have the same after-federal-tax yield as the tax-exempt bond fund. As an example, the highest-yielding long-term bond fund, USAA Tax Exempt: Long Term, yields 5.6% and is exempt from federal income tax. To determine the taxable equivalent yield, divide the tax-exempt yield by 1.00 minus your marginal federal income tax rate in decimal form. Using the highest marginal federal rate on income, 39.6%, the taxable equivalent yield on this fund is 9.3%:

$$\text{Taxable equivalent yield} = \frac{\text{tax-exempt yield}}{1.00 - \text{marginal federal inc. tax rate}}$$

$$9.3\% = 5.6\% \div (1.0 - 0.396)$$

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TABLE 1. TAX-EXEMPT BOND FUND CHARACTERISTICS

Short-Term Funds (Ticker)	Yield (%)	Tax-Equiv. Yield (%)		Annual Return (%)			Avg. Maturity (Years)	Std. Dev. (%)	Expense Ratio (%)	Phone
		39.6%*	15.0%*	One Yr.	Three Yrs.	Five Yrs.				
Strong Sht Tm Muni Bond (STSMX)	4.8	7.9	5.6	3.5	5.4	4.5	2.7	1.4	0.60	800-368-1030
USAA Tax Ex:Short Term (USSTX)	4.5	7.5	5.3	3.2	4.7	4.9	2.4	1.1	0.38	800-531-8181
Dreyfus Short Int Muni Bd (DSIBX)	4.1	6.8	4.8	3.3	4.3	4.3	2.3	1.0	0.76	800-782-6620
Strong Municipal Advtg (SMUAX)	4.0	6.6	4.7	3.9	4.7	—	> 1.0	0.5	0.50	800-368-1030
Fidelity Spart Sh Int Mun (FSTFX)	3.9	6.5	4.6	3.2	4.5	4.7	3.0	1.5	0.55	800-544-8888
Vanguard Muni:Short Term (VWSTX)	3.7	6.1	4.4	3.3	3.9	4.0	1.2	0.6	0.20	800-635-1511
Calvert Tx Fr Rsv:Ltd/A (CTFLX)	3.4	5.6	4.0	4.2	4.0	4.1	1.0	0.6	0.70	800-368-2750
<b>Intermediate-Term Funds (Ticker)</b>										
USAA Tax Ex:Intmed Term (USATX)	5.3	8.8	6.2	2.4	6.4	6.6	10.0	2.8	0.36	800-531-8181
Vanguard Muni:Intmed Tm (VWITX)	5.0	8.3	5.9	2.3	5.2	5.7	7.0	2.7	0.21	800-635-1511
Scudder Managed Muni Bond (SCMBX)	5.0	8.3	5.9	1.8	6.2	6.6	8.9	3.7	0.62	800-225-2470
Fidelity Spart Int Muni (FLTIX)	4.8	7.9	5.6	2.4	5.7	6.2	8.6	2.7	0.50	800-544-8888
Dreyfus Intmed Muni Bond (DITEX)	4.8	7.9	5.6	1.8	5.3	5.6	8.8	2.9	0.74	800-782-6620
AARP Tax Fr:Ins General (AITGX)	4.7	7.8	5.5	1.4	5.5	6.0	9.5	3.7	0.62	800-253-2277
Scudder Medium Term Tx Fr (SCMTX)	4.6	7.6	5.4	1.9	5.4	5.7	6.1	2.9	0.72	800-225-2470
Allghny:Chicago Tr Mu Bnd (CHTMX)	4.6	7.6	5.4	1.7	4.2	4.5	8.5	2.5	0.35	800-992-8151
SteinRoe Muni:Intmed (SRIMX)	4.6	7.6	5.4	2.0	5.2	5.5	8.5	3.0	0.70	800-338-2550
Dreyfus BASIC Intm Muni (DBIMX)	4.6	7.6	5.4	2.5	6.3	6.4	9.1	3.2	0.45	800-782-6620
T Rowe Price Sum:Muni Int (PRSMX)	4.5	7.5	5.3	2.3	5.8	6.1	6.6	2.8	0.50	800-638-5660
Amer Cnt:Intm Tax Free (TWTIX)	4.5	7.5	5.3	2.3	5.2	5.5	8.5	2.9	0.51	800-345-2021
T Rowe Price TF:Int Fd (PTIBX)	4.4	7.3	5.2	2.1	5.2	5.6	8.5	3.0	0.65	800-638-5660
Babson Tx Fr Inc:Port L (BALTX)	4.4	7.3	5.2	1.7	5.6	5.9	8.8	3.3	1.06	800-422-2766
Vanguard Muni:Limited Tm (VMLTX)	4.3	7.1	5.1	3.1	4.5	4.6	3.4	1.5	0.21	800-662-2739
Legg Mason Tx Fr:Int In/P (LTITX)	4.3	7.1	5.1	2.1	4.5	5.0	7.7	2.4	0.70	800-822-5544
Boston 1784 TE Medium Inc (SETMX)	4.3	7.1	5.1	1.8	6.0	6.2	9.2	3.3	0.80	800-252-1784
Marshall:Intm Tax Free Fd (MITFX)	4.2	7.0	4.9	1.8	4.9	5.1	8.0	2.9	0.61	800-236-8554
Payden & Rygel Tx Ex Bd/R (PYTEX)	4.2	7.0	4.9	2.2	5.2	5.5	8.8	2.9	0.49	800-572-9336
Scudder Limited Term TF (SCLTX)	4.1	6.8	4.8	2.6	4.5	4.7	3.7	1.8	0.75	800-225-2470
Neuberger Muni Sec Trust (NBMUX)	4.1	6.8	4.8	2.2	5.1	5.2	7.7	3.0	0.65	800-877-9700
T Rowe Price TF:Short Int (PRFSX)	4.0	6.6	4.7	2.9	4.4	4.6	4.1	1.6	0.53	800-638-5660
Amer Cnt:Ltd Tax Free (TWT SX)	3.9	6.5	4.6	2.9	4.3	4.5	3.6	1.6	0.52	800-345-2021
Schwab Inv:Sht/Int Tx Fr (SWITX)	3.9	6.5	4.6	2.6	4.2	4.5	4.3	1.6	0.49	800-266-5623
Excelsior Intm Tax Exmpt (UMITX)	3.9	6.5	4.6	2.0	5.4	5.9	8.6	2.9	0.58	800-446-1012
Northern Intm Tax Exmpt (NOITX)	3.8	6.3	4.5	2.2	4.5	4.8	6.5	2.4	0.85	800-595-9111

\*Marginal federal tax rate

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Of course, the lower the marginal federal tax rates that an investor has, the lower the taxable equivalent yield, and for low tax bracket investors, fully taxable bonds and bond funds may be more appropriate. As a comparison, the yield on a U.S. government bond of the same approximate maturity is currently about 6.1%. For an individual at the 15% marginal tax rate, a 5.6% tax-exempt yield would have a taxable equivalent yield of 6.6%, while a 5.0% tax-exempt yield would have only a 5.9% taxable equivalent yield.

The average annual one-year, three-year, and five-year returns in Table 1 are total returns—income plus capital gains or losses. Because returns include gains and losses due to changes in interest rates—when interest rates rise, bond prices fall, and when interest rates fall, bond

prices rise—yields and returns move in opposite directions. Lower bond prices translate into higher yields, but lower bond prices produce capital losses, lowering returns.

## MATURITIES AND RISK

Maturity is important for the usual two reasons: return and risk. If you want higher yields and returns on average, you will have to go to funds with longer maturities, as the summary statistics on the bottom of Table 1 on page 10 show. However, as is apparent from looking at individual fund experience, longer maturity does not always lead to higher yields or returns. Recall the impact a change in interest has on bond funds—if interest rates rise, bond prices drop—but the prices drop further the longer the average maturity of the bond fund.

The impact of maturity on risk can be seen in the column next to maturity in Table 1, which is standard deviation, a measure of return volatility. The larger the standard deviation, the greater the risk. Glance at the average standard deviation by maturity class at the bottom of Table 1. Long-term tax-exempt bond funds have on average over three times the standard deviation of short-term tax exempt bond funds, three times the risk.

The expense ratio, expressed as a percentage of net asset value, tells just how much of your yield is lost to fund expenses. Higher expense ratios mean lower yields. The average expense ratio for these funds is 0.58%. Funds with expense ratios approaching 1.00% are expensive and funds with ratios closer to 0.25% are cheap.

There is more information than in

TABLE 1 CONTINUED. TAX-EXEMPT BOND FUND CHARACTERISTICS

Long-Term Funds (Ticker)	Yield (%)	Tax-Equiv. Yield (%)		Annual Return (%)			Avg. Maturity (Years)	Std. Dev. (%)	Expense Ratio (%)	Phone
		39.6%*	15.0%*	One Yr.	Three Yrs.	Five Yrs.				
USAA Tax Ex:Long Term (USTEX)	5.6	9.3	6.6	1.6	6.7	6.8	15.9	3.3	0.36	800-531-8181
Vanguard Muni:High Yield (VVAHX)	5.4	8.9	6.4	2.5	6.4	7.0	12.6	3.2	0.20	800-635-1511
Vanguard Muni:Ins Long Tm (VILPX)	5.3	8.8	6.2	2.3	6.1	6.8	11.2	3.6	0.21	800-635-1511
Strong Municipal Bond (SXFIX)	5.2	8.6	6.1	2.3	7.5	6.1	11.4	3.4	0.70	800-368-1030
Vanguard Muni:Long Term (VWLTIX)	5.2	8.6	6.1	2.0	6.2	7.0	12.1	3.5	0.21	800-635-1511
SteinRoe Muni:Managed (SRMMX)	5.1	8.4	6.0	1.6	6.1	6.3	15.7	3.5	0.72	800-338-2550
T Rowe Price TF:Income (PRTAX)	5.1	8.4	6.0	1.8	6.1	6.6	15.9	3.5	0.55	800-638-5660
Dreyfus Gen Muni Bond (GMBDX)	5.1	8.4	6.0	0.7	5.4	5.8	21.3	3.2	0.87	800-645-6561
Sit Tax Free Income Fund (SNTIX)	5.0	8.3	5.9	2.5	6.6	6.8	17.2	2.4	0.71	800-332-5580
Dreyfus Muni Bond (DRTAX)	5.0	8.3	5.9	1.2	5.5	5.8	22.3	3.1	0.73	800-645-6561
Dreyfus BASIC Muni Bond (DRMBX)	4.9	8.1	5.8	2.3	7.3	7.4	17.1	3.6	0.45	800-782-6620
Amer Cnt:Long Tm Tax Free (TWTLX)	4.9	8.1	5.8	1.0	6.1	6.5	19.4	4.2	0.51	800-345-2021
SAFECO Muni Bond (SFCOX)	4.9	8.1	5.8	1.3	6.7	7.1	23.9	4.4	0.51	800-426-6730
Janus Inv:Federal Tx Ex (JATEX)	4.8	7.9	5.6	1.7	5.4	6.1	10.2	3.7	0.65	800-525-8983
T Rowe Price Sum:Muni Inc (PRINX)	4.8	7.9	5.6	1.8	7.2	7.5	16.5	3.6	0.50	800-638-5660
Schwab Inv:Long Tm Tx Fr (SWNTX)	4.7	7.8	5.5	0.6	6.0	6.5	19.7	4.0	0.49	800-266-5623
Dreyfus Insured Muni Bond (DTBDX)	4.7	7.8	5.5	1.9	5.7	5.4	23.0	3.6	0.85	800-782-6620
Value Line Tx Ex:High Yld (VLHYX)	4.6	7.6	5.4	1.7	5.7	6.2	20.0	3.2	0.63	800-223-0818
ABN AMRO:TxEx Fxd Inc/Cmn (RTETX)	4.4	7.3	5.2	1.7	6.0	6.2	15.8	3.6	0.83	800-443-4725
Excelsior Long Term Tx Ex (UMLTX)	4.2	7.0	4.9	0.6	6.5	7.8	24.0	4.2	0.74	800-446-1012
Northern Tax Exempt (NOTEX)	4.1	6.8	4.8	1.8	5.7	6.1	16.0	3.9	0.85	800-595-9111
INVESCO TF Inc:TF Long Bd (FTIFX)	4.0	6.6	4.7	1.2	5.0	5.6	10.2	3.8	0.91	800-525-8085
<b>Averages</b>										
<b>Overall</b>	<b>4.5</b>	<b>7.5</b>	<b>5.4</b>	<b>2.1</b>	<b>5.5</b>	<b>5.8</b>	<b>10.7</b>	<b>2.8</b>	<b>0.58</b>	
<b>Short Term (three years or less)</b>	<b>4.1</b>	<b>6.7</b>	<b>4.8</b>	<b>3.5</b>	<b>4.5</b>	<b>4.4</b>	<b>2.1</b>	<b>0.9</b>	<b>0.53</b>	
<b>Intermediate Term (three to 10 years)</b>	<b>4.4</b>	<b>7.3</b>	<b>5.2</b>	<b>2.2</b>	<b>5.2</b>	<b>5.5</b>	<b>7.4</b>	<b>2.7</b>	<b>0.58</b>	
<b>Long Term (greater than 10 years)</b>	<b>4.9</b>	<b>8.1</b>	<b>5.7</b>	<b>1.6</b>	<b>6.2</b>	<b>6.5</b>	<b>16.9</b>	<b>3.6</b>	<b>0.60</b>	

\*Marginal federal tax rate

Source: AAIL's Quarterly Low-Load Mutual Fund Update/Standard &amp; Poor's Micropal. Data as of June 30, 1999.

Table 1 that you need to know in order to intelligently select a municipal bond fund. Get the prospectus and annual report (which contains a list of all securities in the portfolio) of the fund and follow this check list:

- What quality are the bonds? Other than high-yield funds, most municipal bond funds have almost all of their portfolio in AAA and AA-rated bonds, with a few perhaps in the A-rated category. High-yield funds will have most in BBB bonds, lower-quality bonds that have higher default risks.
- What percentage of the portfolio is in general obligation bonds? General obligation bonds are backed up by the full faith and credit of the issuer and are lower risk than special purpose bonds, which are dependent upon revenues from specific projects.
- Does the fund hold bonds subject to the alternative minimum tax (AMT)? The interest on municipal

bonds that are issued for private use is subject to the dreaded alternative tax, so if you want to avoid even doing the AMT calculation, then avoid funds with AMT-type bonds.

- How many different bond issues does the fund hold? Most funds hold well over 100 issues, with some pushing 400. Geographic and issuer diversity is important. Single-state bond funds carry additional risks, although they have the benefit of double or triple tax exemption, because they are concentrated and subject to the risks of state or city fiscal woes.
- What is the investment philosophy of the fund—does it offer high yield or high quality? Do you want to rely on diversification to blunt any defaults and go for high yield or do you want to sacrifice some yield for the security of high quality bonds?
- What is the investment style of the fund—is the manager betting on

interest rate moves, shortening the portfolio maturity on expectations of interest rate increases or lengthening maturity in anticipation of interest rate drops? This kind of active style management would be appropriate if you think it is possible to consistently forecast the direction of interest rates correctly. If you want to avoid most of the risk of your bond fund dropping in value when rates rise but don't want to give up substantial yield, think intermediate-term funds.

## THE END GAME

Tax-exempt bond funds have the same end game in mind as you do, minimizing taxes, but often decidedly different strategies.

So, bat these questions around until they are answered to your satisfaction, and you should find several funds that closely match your yield, risk, and tax-shielding preferences. ♦