

How Safe Are Municipal Bonds?

By Annette Thau

Article Highlights

- Default rates among municipal bond issuers are extremely low.
- Genuine concerns include rising interest rates, increased bond issuance and headline risk.
- Individual municipal bonds, held to maturity, may be safer than aggressive bond funds.

Between November 2010 and the end of January 2011, municipal bond funds declined by an average of about 6%, although some declined by as much as 11%.

Declines in the price of municipal bonds (“munis”) are nothing new. Two significant declines occurred in 2008: the first in February 2008, and the second a virtual meltdown that took place as the financial panic of 2008 unfolded. Both declines were discussed in articles I wrote for the *AAII Journal* [past articles are available at AAII.com]. But one aspect of the most recent decline that distinguishes it from prior episodes is that it is generating heated and controversial discussions in the financial press and media. This is new. Unfortunately, much of this discussion is not well informed.

Much of the current discussion starts with a forecast made by Meredith Whitney, a highly regarded bank analyst, last December on “60 Minutes.” During that broadcast Whitney predicted that massive defaults were likely to occur in the municipal bond market. More specifically, she predicted 50 to 100 “sizeable defaults” generating “hundreds of billions of dollars” of losses. By now, that forecast has been repeated endlessly. Those who feel her forecast is justified cite two potential problem areas: first, general stress on the finances of issuers of municipal bonds such as states, counties and cities due to the continuing economic downturn; and, second, future problems due to significant unfunded liabilities



for pension funds and the costs of healthcare to retirees.

A closer look at Whitney’s statement makes it very clear why knowledgeable analysts consider it to be highly exaggerated. Their objections center on the prediction of 50 to 100 “sizeable” defaults and the forecast of “hundreds of billions” of dollars of losses. Bear in mind that there are well over 55,000 municipal bond issues outstanding. In any given year, as

many as 50 to 100 defaults do occur in the municipal bond market, although that number varies. But even if as many as 100 defaults do occur, say, within a year, that translates into a minuscule default rate: less than one-third of 1% of all outstanding municipal bonds. Moreover, these defaults tend to be concentrated among tiny issuers of bonds that fall into certain categories of municipals considered to be riskier: unrated bonds and those issued by private-purpose entities, such as nursing homes. Moreover, total aggregate amounts of defaulted bonds are in the range of \$5 billion to \$10 billion per year. So predicting hundreds of billions of dollars worth of defaults is either hype or a wild and careless exaggeration.

But while it is easy to dismiss this particular statement as hype, that does not mean that the road ahead for municipal bonds is without risks. Meredith Whitney’s prediction deals primarily with one risk—credit risk. But current buyers should be equally aware of two other types of risks. The first is the risk that prices will decline if interest rates rise—interest rate risk. The second, which has played an increasing role

in all three of the recent declines in the municipal bond market, is “sell-off” risk—panic selling that creates a severe imbalance between buyers and sellers.

This article will briefly attempt to answer a number of questions:

- What lies behind the current (and recent) decline in muni bond prices?
- Has the current decline created a buying opportunity?
- What are some sources of concern?
- For the risk averse, where can you find safety?

Causes of Recent Declines

Prior to 2008, most declines in the price of muni bonds were tied to a rise in interest rates. But the declines of 2008 had more complex causes. Declines in early 2008 followed a year of headlines about two separate crises: the auction-rate securities (ARS) mess, which saw investors in these securities unable to redeem them, and the downgrades of bond insurance firms from AAA to their current ratings, which are well below investment grade (that is, to levels appropriately qualified as junk). Those downgrades, incidentally, were due not to losses in their municipal bond portfolios, but rather to investments in defaulted mortgage-backed securities. At the moment, only one bond insurance firm still has a high rating: Assured Guarantee Municipal Company (AGMC), currently rated AA. (As a result of the downgrades of the major bond insurance firms, only about 6% of all municipal bonds now come to market with insurance, compared with about 55% up to 2007.)

Much steeper declines in muni bond prices occurred in the fall and winter of 2008. These declines were due primarily to a wave of selling by large institutional holders of municipal bonds: hedge funds and pension funds desperate to raise cash and selling any securities that were considered to have high credit quality in order to raise that cash. At the same time, there was an almost complete absence of buyers. This enormous imbalance between buyers and sellers resulted in totally

unprecedented losses in municipal bonds—well out of proportion to any real risk. Many bond funds declined by anywhere from 20% to 50% within a matter of months.

The most recent declines in the price of municipal bonds began well prior to Whitney’s forecast, during the second week of November 2010. Once again, the initial cause was an imbalance between buyers and sellers. This was the result of a rush to issue bonds prior to the end of the year. (This stampede was due in part to uncertainty about the continuation of the Build America Bonds program. Issuers rushed to issue bonds in anticipation of the program’s termination—and, in fact, to date it has not been extended.) The flood of new issues was simply more than the market could absorb at the time, and prices began declining.

These declines were exacerbated by massive outflows from bond mutual funds. According to Lipper data, during November and December of 2010 and January 2011, bond funds experienced net outflows of about \$37 billion. That amount more than wiped out net inflows of \$30 billion between January and October of 2010. Individual investors may have been selling to cash in profits (muni bond funds had rallied significantly through 2009 and 2010), or they may have been selling because prices began declining. Individual investors who remembered the horrendous declines of 2008 can be forgiven for being jittery. In all likelihood, Whitney’s statement—echoed and “analyzed” endlessly by the media—added to investor concerns. Investor concern was also fed by analogies between municipal bonds and the bonds of certain debt-plagued European countries (Ireland, Spain, Portugal and Greece).

The Lowdown on Credit Quality

While Meredith Whitney’s statements appear to be wildly exaggerated, current discussions of credit quality point to some genuine concerns. Revenues are declining for issuers at all levels—states and cities and issuers of

revenue bonds such as water, toll roads or electricity. Finances are stressed everywhere. Many states and cities are also facing underfunded pension liabilities and rising health care costs. Are these problems so serious that they will lead, as Whitney suggested, to a significant rise in defaults?

Observers who know the municipal bond market do not think so. The reasons may be summarized as follows:

- Issuers of municipal bonds set aside very clear sources of revenues for debt service. For most states and municipalities, debt service constitutes a relatively small portion of total expenditures, generally 4% to 8%. General obligation bonds are backed by the taxing power of the issuer. Issuers of revenue bonds can and do raise rates to customers. (Analogies based on the debt problems of foreign countries are totally misplaced.)
- Most state constitutions require that state budgets are balanced every year. State governments are not allowed to file for bankruptcy protection. Only 26 states allow municipalities to file for bankruptcy, and only under extremely complex procedures.
- More importantly, large issuers of municipal bonds depend on those bonds to fund critical continuing operations and capital budgets. A default that would shut off access to credit markets is simply not an option.
- No state has defaulted since the Great Depression. (Only one state, Arkansas, defaulted during that depression.) Default rates among issuers of municipal bonds are extremely low—municipal bonds are considered next to Treasuries in credit safety. Default rates are historically about one-third of 1%. In fact, even among the lowest-rated municipal bonds, default rates are lower than those of corporations rated AAA. Even though there have been a few highly publicized municipal bond defaults (Washington Public Power, Orange County,

New York City), those were exceptions and highly publicized for that reason.

- Issuers are doing whatever they need to do to shore up finances. Many states and cities are furloughing and firing workers as well as negotiating with unions to cut benefits for new hires.
- Unfunded pension liabilities and rising health care costs are longer-term problems, but they do not constitute an imminent liquidity problem. Large issuers have the time to address the problem and the means to solve it.

One piece of evidence as to the soundness of municipal bonds that seems to have been totally ignored by the media is the change in the rating scales of municipal bonds. Prior to the financial panic of 2008, many observers had pointed out that, if rating scales were based primarily on default history, then the rating scales used by the rating agencies significantly overstated the risk of municipal bonds. During 2008, the three rating agencies (Moody's, Standard & Poor's, and Fitch) came under severe criticism primarily because they had rated mortgage-backed securities AAA, and as they began defaulting, those securities were downgraded to junk. But these criticisms led to a broad re-assessment of bond ratings in all sectors. The one sector where the rating scales were actually changed as a result of this review was the municipal bond area. In May 2010, thousands of municipal bonds were upgraded. This change in the rating scales was called a "recalibration": In other words, the rating agencies pointed out that prior rating scales had overstated the default risk (i.e., the riskiness) of municipal bonds. These recalibrated ratings are currently in effect. Though occasional downgrades still occur, as they always have, the changed rating scales are a reminder that municipal bonds constitute an asset class with generally high credit quality.

Note one other factor that may contribute to further confusion going forward. As I am writing this, a

congressional committee is holding hearings to determine whether to pass legislation that would allow states to go bankrupt. It is not totally clear who is behind this initiative and why. Most governors are against any legislation that would permit bankruptcy because that very prospect would result in higher borrowing costs. Proponents of the legislation seem to have two reasons for this agenda. The first is to make sure that the federal government does not ever bail out states. But the second is to give states the ability to club unions into cutting benefits. At press times, it seems the committee is leaning against legislation to allow bankruptcy, but in favor of requiring fuller disclosure of pension obligations.

Has a Buying Opportunity Been Created?

Have the recent declines in the municipal bond market created a buying opportunity similar to the one that prevailed at the end of 2008? How "cheap" are municipal bonds currently?

The usual "metric" for evaluating whether munis are particularly cheap is to compare the yield of benchmark issues, typically 10-year and 30-year AAA municipal bonds, to the yield of Treasury bonds of the same maturity. Prior to 2008, based on their exemption from federal taxes, municipal bonds were considered attractive if those yields were anywhere between 80% and 85% of Treasury yields. Ratios of AAA munis to Treasuries were close to 100% of Treasuries only for the briefest periods of time. This was partly due to the fact that at that level, so-called crossover buyers such as hedge funds or pension funds would buy municipal bonds for their yield as well as for the possibility of earning capital gains when yields returned to "normal." Bear in mind that bonds rated A+ and AA, while still high-quality credits, have higher yields than bonds rated AAA.

At their most recent lows, in the middle of January, yields of 10-year and 30-year AAA munis were both above 100% of Treasury yields. As I am writ-

ing this (mid-February 2011), municipal bond yields have rallied somewhat from these lows. Yields of 10-year AAA munis are approximately 92% of 10-year Treasury yields; yields of 30-year AAA munis are approximately 105% of Treasury yields. These ratios are high compared to ratios that prevailed prior to 2008, but not nearly as high as those reached during the sell-off of late 2008. During that sell-off, yields of AAA munis reached 150% to 200% of Treasury yields at every point on the yield curve; yields of lower-quality muni credits were even higher. Moreover, yields remained at these elevated levels for months. So at current levels, yields of municipal bonds are attractive compared to Treasuries. But given recurring crises in this sector of the bond market, munis should not be considered screaming buys. There is no guarantee that prices will not decline from current levels.

Note, also, that these ratios are dynamic and change continually. While municipal bond yields typically follow those of Treasuries, the two are not always in sync. In fact, that is the reason why, occasionally, munis become "cheap" or "expensive" relative to Treasuries. If, for example, prices of munis rise and those of Treasuries do not, then the ratio of munis to Treasuries is lowered. A ratio where munis yield 80% of Treasury yields does not mean munis should not be bought for income, but it also does not represent a compelling buying opportunity.

Nonetheless, on an absolute basis, yields of municipal bonds remain attractive. Because of the tax exemption of municipal bonds, a yield of 3.5% on a municipal bond is equivalent to 4.9% on a taxable bond for an investor in a 28% bracket, and equivalent to 5.0% for an investor in a 31% bracket. A yield of 4.5% tax exempt is equivalent to about 6.25% on a taxable bond for an investor in a 28% bracket, and equivalent to 6.5% for an investor in a 31% bracket. (The taxable-equivalent yield of a municipal bond can easily be found on the Investinginbonds.com website).

Yields in that range are currently available for intermediate maturities,

that is, bonds maturing in eight to 14 years. For example, trolling for bonds online, for the state of New Jersey (where I live), I saw many bonds listed for sale that were rated A+ or AA, maturing between eight and 14 years and yielding between 4% and 5%, tax exempt. On a tax-equivalent basis, those yields are significantly higher than those of Treasuries with comparable maturities. But they are also higher than those of taxable corporate bonds with much lower credit quality. (Muni bonds rated A+ and higher have virtually no default history.) You can get even higher yields, 5% to 5½% (tax exempt), on munis with longer maturities. But I have never been comfortable recommending bonds with the longest maturities because they are much more volatile and much more expensive to sell. Surprisingly high yields (again on a tax-equivalent basis) can also be found in much shorter maturities—three to five years—rated A+ or higher. Currently, bonds fitting those criteria can be found that yield from 2½% to 3½% (tax exempt), again well above the yields of taxable bonds with similar maturities and credit quality.

Sources of Concern

In spite of their attractive yields and high credit quality, you should be aware of some potential problems in the municipal bond market.

Interest Rates May Rise

For the moment, debates about default risk have dominated the discussion and interest rate risk has fallen off the radar screen. But clearly, and particularly in light of the fact that interest rates are currently historically very low, this is the proverbial elephant in the room. Interest rates of municipal bonds typically follow those of Treasuries. If interest rates rise on Treasuries, then interest rates on municipal bonds are likely to follow: The price of all bonds declines whenever interest rates rise.

It is not possible to discuss interest rate risk in detail within the confines of a brief article. [For more, see “Why Bond Prices Go Up and Down” in the

Investor Classroom area on AAII.com.] The basic fact to bear in mind is that if interest rates rise, the price of a bond declines. If interest rates decline, the price of a bond rises. Changes in the price of a bond are related directly to maturity length. For bonds that mature in a year or less, interest rate risk is negligible. Interest rate risk rises gradually as maturities lengthen. It is highest for bonds with the longest maturities.

Interest rate risk is a more significant concern for investors in bond funds than for those who buy individual bonds. If you buy individual bonds and hold them to maturity, when the bond matures, you recover principal in full, no matter what has happened to interest rates during the time you held the bond. (Note, however, that while you hold the bond, its price may fluctuate with interest rates, or with changes in the market. Such changes affect long-term bonds more significantly than short-term bonds.)

Over short-term periods, however, interest rate risk is significant for holders of long-term bond funds. The great majority of bond funds maintain what is known as a “constant maturity.” With a few exceptions, there is no date at which the entire portfolio matures. As a result, the share price of a bond fund goes up and down with interest rates. When you buy a bond fund, it is impossible to predict its share price—that is, its net asset value (NAV)—at any point in the future. The price at which you sell a bond fund may be higher or lower than your original purchase price. Changes in net asset value due to changes in the level of interest rates are one reason returns of bond funds have been so high over the past three decades: Over that 30-year span, interest rates have been declining. As a result, the dividend yield of bond funds has been boosted by a significant rise in the net asset value of bond fund shares.

But if interest rates start to trend higher, then declines in the share price—the net asset value—of bond funds will significantly limit returns or cause them to go negative. This is particularly important for municipal bond funds

because the great majority are long term and therefore are most affected by interest rate risk. Note also that the most aggressive funds compound the problem by also investing in lower-quality credits in order to quote higher yields. And the lower credit quality of these funds magnifies declines.

You can determine how sensitive a bond fund is to changes in interest rates by looking up the “duration” of the fund. Duration is a technical concept that adjusts maturity for bond cash flows—for example, the size of coupons, or whether bonds are premium or discount. You need not understand how duration is derived to be able to use the concept. Duration, expressed in years, measures sensitivity to changes in interest rates. It can be used as an approximate gauge to determine how much a fund’s net asset value will move up or down in response to a change in interest rates of 1% (100 basis points). For example, if you own a bond fund with a duration of eight years, then a rise in interest rates from 4% to 5% would result in a decline of 8% in the fund’s net asset value. (Duration is published by mutual fund families along with other characteristics of a bond fund.)

Even though the most recent declines in the municipal bond market were due to an imbalance between buyers and sellers, declines in bond funds were still largely determined by the average maturity of the fund. For example, between the beginning of November and the end of January, bond funds with long average maturities declined 5.85%, on average. Bond funds with short-term maturities (under two years) averaged declines of less than one-half of 1%. The most volatile funds are so-called “high-yield” funds: They tend to have the longest maturities and many also hold weaker credits. During the same period, high-yield funds averaged declines of more than 7%, with the worst experiencing declines above 11%.

Historical returns have shown that the “sweet spot” among bond funds tends to be so-called “intermediate” funds. Those are funds with average maturities between six and eight years

and high credit quality. During the most recent sell-off, declines of these funds averaged 3.5%. Over long holding periods (10 years or more), because intermediate funds are much less volatile than long-term funds, conservatively managed intermediate municipal bond funds (that is, intermediate funds that have low expense ratios and high-quality credits) often have higher and more consistent returns than many long-term or high-yield funds.

I want to emphasize that I am not predicting that long-term rates will necessarily rise, but a number of things are clear. At some point, the Federal Reserve will raise the rates that it controls, meaning the discount rate and the federal funds rate. These are overnight rates, and they are currently maintained close to zero. When they go up, all short rates, including the three-month, six-month, one-year and two-year rates, will also rise. But there is no way to predict what will happen to longer-term rates. They may also rise, and they may not. (In 2004, the Federal Reserve, under Chairman Greenspan, raised short rates seven times, and longer-term interest rates actually declined). But given the current historically low level of interest rates, this is a risk that investors need to fully understand. As noted above, if rates rise significantly on long-term Treasuries, then in all likelihood, they will rise on municipals. This may not be an immediate concern, but if the economy recovers and if inflation picks up, then it will become a concern.

Increased Bond Issuance

Another concern is that the current rally, tepid as it has been, is taking place at a time when few issuers have been coming to market, primarily because the market has been unsettled. If issuance picks up and individual investors continue to stay away from municipal bonds—whether due to continuing headline risk or because they see more attractive opportunities elsewhere—then munis may resume their decline.

Headline Risk

Finally, it is not clear that the most

recent decline has run its course. As this is being written, bond funds have momentarily stopped declining and have even gone up a bit. But net outflows from municipal bond funds are continuing: about \$1 billion in each of the first two weeks of February, compared to record outflows of close to \$3 billion and \$4 billion during a number of weeks between November and January. But “headline risk” may at some point re-ignite investor concerns.

What Should Individual Investors Do?

The main point of this article is that the current discussion of the municipal bond market overstates credit risk, but ignores other significant concerns.

If you invest in municipal bonds by buying individual bonds that are highly rated and that you hold to maturity, the current furor over credit quality should not be a cause of concern. But if you are investing in a bond fund, you should make sure that you understand its risk profile. The most aggressive funds invest in the longest-term bonds and those with lower-quality credits. These funds quote the highest yields, but are the most volatile. If you are the type of investor who is not comfortable with volatility, the aggressive funds are not appropriate holdings. You want to avoid panic-selling when these funds decline; this is unfortunate, but typical, investor behavior. You can investigate a fund's risk profile by looking up its duration and the composition of its portfolio. But it would also be instructive to investigate its performance during all three recent declines. (These numbers are available on the fund family websites and on Morningstar.com.)

If you are investing new money, as noted earlier, yields in the municipal bond market are attractive on an absolute basis. If your portfolio is large enough (above \$50,000), given uncertainties about the direction of interest rates, my recommendation would be to buy individual bonds rather than bond funds. If you hold them to maturity (barring the unlikely possibility of de-

fault), you will get back 100% of your principal, no matter what happens to interest rates while you hold the bond. I would further suggest that you stick to bonds with high credit quality (A+ or better) and that before you buy, you understand the sources of revenue backing the bond. Finally, I would recommend that you buy bonds that are maturing in eight to 12 years at the most.

Why not buy longer-term bonds with higher yields? The answer is that the price of the longest maturity bonds is much more volatile than that of intermediate bonds. And they are much more expensive to sell if the need arises. If you can earn 80% or even 90% of the yield of longer-term bonds with much lower risk, as it is possible to do at the current time, why would you want to take on the added risk?

If you are not comfortable buying individual bonds, as noted above, the “sweet spot” for municipal bond funds is to be found in conservatively managed bond funds with intermediate maturities, low expense ratios (below one-half of 1%) and high-quality credits (at least 50% of the portfolio should be investment grade or higher—that is, A to AAA). Returns of such funds are higher than those of money market funds. And over long holding periods, conservatively managed bond funds such as these have achieved returns equal to those of riskier longer-term funds, with far lower price declines in times of stress and far less volatility.

If you are investing money that you will need to spend over the next few years, then you should stick to either high-quality individual bonds that mature in two or three years or money market funds. Another alternative is bond funds that have average weighted maturities of two years or less. As noted above, during the most recent declines, these funds averaged losses of less than one-half of 1%. The trade-off, of course, is that current yields of these funds are also below 1%. But these yields will rise whenever the Federal Reserve finally raises short-term rates.

If you have a more speculative bent, and if you are looking for the highest

possible yields, the best opportunities are currently to be found in closed-end municipal bond funds. This article has not discussed closed-end funds, which constitute a somewhat arcane corner of the bond fund market. Most closed-end municipal bond funds are leveraged, and leverage boosts both yield and

volatility. Volatility in these funds is very high: During the most recent sell-off, declines in share price averaged around 14%. But closed-end funds are worth mentioning because recent declines have resulted in extremely attractive yields: Many closed-end municipal bond funds are sporting tax-exempt yields of 6.8%

to 6.9%. Two excellent free sources of information are CEF Connect (www.cefconnect.com) and the Closed-End Fund Association (www.cefa.com).

Finally, given all the uncertainties in the current environment, it would seem prudent to invest gradually, over a period of months. ▲

Annette Thau is the author of "The Bond Book: Everything Investors Need to Know About Treasuries, Municipals, GNMA's, Corporates, Zeros, Bond Funds, Money Market Funds, and More." The third edition of this book, fully revised and updated, was published by McGraw-Hill in November 2010. Many of the topics discussed or alluded to in this article (interest rate risk, duration, bond fund returns, how to buy individual bonds) are discussed at length in the book. Annette has also written more than 20 articles for the AAI Journal. Find out more about Annette at www.aai.com/authors/annette-thau.

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Company	30.0	17.2	11.4	13.3	12.7	14.1	11.9	11.8
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Sector	42.6	29.3	28.7	30.6	28.5	29.3	29.9	31.6
Industry	42.0	24.4	24.7	23.6	22.6	23.6	23.3	26.3
Operating Margin								
Company	10.4	9.0	5.9	6.9	6.2	7.0	6.6	6.7
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