



## Bonds - A Formidable Investment in Today's Scary Times

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From modest beginnings eight hundred years ago, in city-states of northern Italy, the market for bonds has grown to a vast size. The total value of internationally traded bonds today is around \$18 trillion. Governments and corporations issue bonds as a way of borrowing money from a broader range of people and institutions than just banks.

There are several kinds of bonds available to investors: Treasuries, Agencies (e.g. bonds issued by Fannie Mae), Municipals (e.g. bonds issued by city of Chicago), Corporates (e.g. bonds issued by Johnson & Johnson), and internationals (e.g. bonds issued by Brazil). We will discuss these bonds in further detail in future newsletters.

Yields on bonds vary greatly, particularly in today's market. With the current flight to safety, ten year treasury bonds are yielding close to 2%. Investment-grade corporate bonds are yielding 5-8%. Municipal bonds are yielding 3-6%. Hi-Yield Bonds (aka "Junk bonds") are more risky than investment-grade bonds and are yielding 12% or more.

For a number of reasons, we believe that municipal bonds should be considered at this time for investors at or near the highest income tax brackets as part of their fixed income exposure.

Municipal bonds are unique first because of their issuers. A **municipal bond** (or "muni") is a bond issued by a city or other local government, or their agencies.

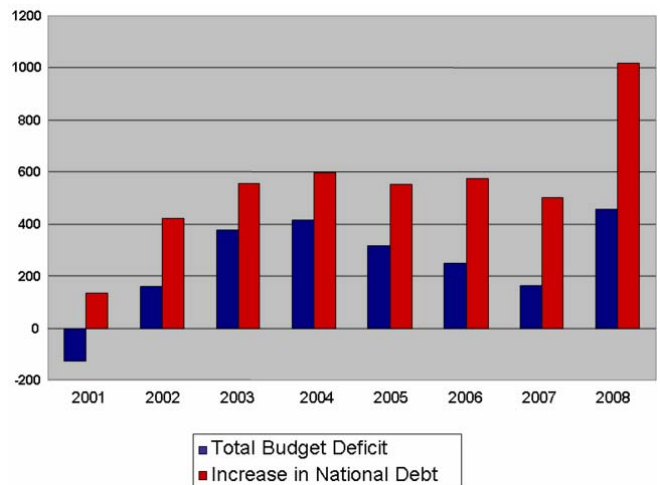
Potential issuers of municipal bonds include cities, counties, school districts, publicly owned airports and any other governmental entity (or group of governments) below the state level. Municipal bonds may be general obligations of the issuer (e.g. full faith and credit of the State of California) or secured by specified revenues (e.g. revenues from a new stadium or a new waterworks and sewer system).

Second, interest income received by holders of municipal bonds is often exempt from the federal income tax and from the income tax of the state in which they are issued.

Since the interest income from a muni is tax-exempt, to compare "apples to apples", a simple calculation is needed to compare its yield to the yields of other tax-bearing bonds like corporate bonds. For example, one municipal bond generates 5% interest income annually. The top tax bracket for individuals is 35%. So the Tax-Equivalent Yield is  $5\% / (1 - 35\%) = 7.69\%$ . That means, from an after-tax perspective, the 5% Muni has the same income level as a tax-bearing bond with 7.69% yield.

Then, we should look at where income taxes may be going. Let's take a look at the federal government's deficit first.

Total Deficits vs. National Debt Increases (\$ Billions)



As we can see from the chart above, the budget deficit increased with accelerating speed in 2008 along with a trillion dollar increase in National Debt. And the above data does not include approximately \$4.8 Trillion in government bailouts in the works. More importantly, the majority of the federal expenses are "mandatory" like Social Security, Medicaid & Medicare program. That means the federal government will have a hard time in attempting to cut and limit the growth of spending and expenses. That being said, the only way to pay down the debt and make up for the deficit is to raise taxes. Meanwhile, the individual's top bracket tax rate is at historical lows:

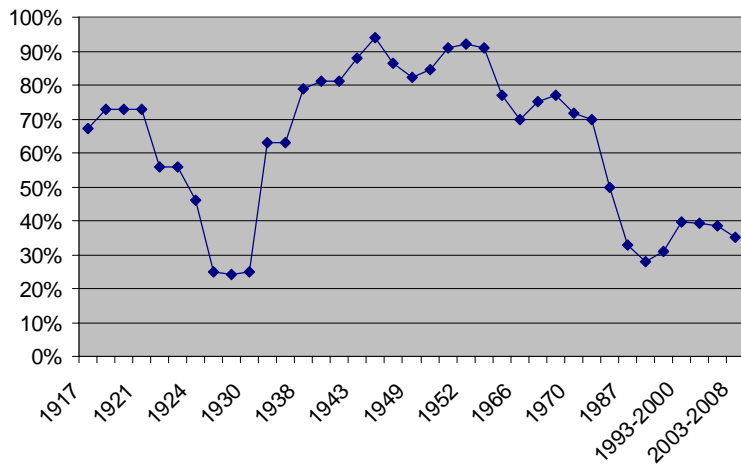
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### WHO'S NEWS?

**Danielle Hershon**  
in our Charleston office!

Please welcome her the  
next time you call!

## Bonds (continued)



While we do not see a 70%~80% tax rate for the top tax bracket in the next decade or so (though it is possible), we do expect the tax rate to increase from historical lows nowadays to a possible 40~50% range in the next few years.

That being said, let's play around with it a little bit more. If the tax rate increases to 50% rather than the current 35%, the new Tax-Equivalent Yield for that same Muni bond in our example would be  $5\% / (1 - 50\%) = 10\%$ , which is a pretty decent yield given the lower risk characteristics of muni bonds. What is more, this is not a virtual example- it is a highly probable real-world scenario in the next decade in our view.

In short, the individual income tax rate for the top tax bracket is due to rise, and this makes municipal bonds more

attractive on an after-tax basis.

One may ask, "Well, what is the risk associated with investing in munis?"

First, there is credit risk. That means if the cities or school district

default on their debt, the bond investors will get hurt. For example, in 1994, Orange County in California defaulted on their debt; in 1970s, the New York City was at the brink of bankruptcy for almost a decade; now California is in serious budget deficit trouble and bankruptcy is a real possibility. DWM manages the credit risk carefully by focusing on high quality issues and looking deeply into the borrower's financial status and their budget situations for the next few years. Moreover, after buying the bonds, we

monitor the credit and budget dynamics of the issuer closely on an on-going basis. We also manage this risk by investing in a diversified bond fund or a diversified bond ladder, with maturities ranging from three to ten years.

Second, of course, there are interest rate risks. If the interest rate rises, the bonds will fall in value. By holding bonds to maturity, we mitigate the risk and volatility of bond prices to the least extent possible. Moreover, from our point of view, the interest rate will likely remain low in the next few years when the economy is struggling through recession before the recovery begins.

On the whole, given the macro trend of tax increases and low-interest environment, we think that municipal bonds are quite attractive from a risk/reward perspective. It is a good way to provide an investor a tax-exempt income stream and protect one's wealth in this scary and volatile market.

Please give us a call to see how bonds can help you meet your financial goals.

## STAY IN TOUCH

We are cleaning up our databases and need your help. Please take a moment to update your contact information with us to be sure you receive important communications. Just send an email to [anna@dwmfnclgroup.com](mailto:anna@dwmfnclgroup.com). Thanks!



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