

Standard & Poor's AdvisorInsight.com Website

By Richard Diennor

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Front Page

Tax Breaks Make Muni Bonds Look Good

Jan. 21, 2005 -- Even if interest rates gradually increase this year, as is widely expected, municipal bonds or muni bond funds remain attractive investments.

Generally, when rates rise slowly, muni bonds retain more of their value than taxable fixed-income securities, observers note.

For people in upper income brackets who hold municipal bonds in taxable accounts, the securities currently provide returns that edge out those of U.S. Treasuries, says Standard & Poor's chief economist David Wyss.

The bonds also make sense for people who live in states with high income tax rates, like California and New York, observers said.

Interest on municipal bonds is not subject to federal income taxes, and for the most part, if you're a resident of the state that issued the bonds the interest is also free from state taxes. Some cities and local governments exempt interest from local taxes, too. However, bonds or shares of bond funds that are sold for a profit are still subject to taxes on capital gains.

Bonds can be bought individually, but for people who don't have a lot of money to invest, funds can make more sense because they provide more diverse portfolios.

For people who have less than \$100,000 to invest in bonds, funds are almost always the better choice, because commissions on purchases of individual bonds can be "staggering," said Gary Schatsky, president of the Objectiveadvice Group, a fee-only financial planning firm based in New York.

Also on the downside, if a portfolio of individual bonds has to be liquidated before maturity, "transaction costs in the form of bid/ask spreads can be punishing," said Paul Winter, the owner of Five Seasons Financial Planning, a fee-only financial planning firm in Holladay, Utah.

Wyss and Hugh McGuirk, who oversees municipal bond portfolios for T. Rowe Price Funds, said that even single-state bond funds can provide diversity, because they hold securities issued by a number of municipalities, as well as the state.

Similar sentiments were expressed by Doug McGinley, a municipal bond fund manager with Fidelity Investments. Because they're more narrowly focused, single-state funds can be more volatile than national municipal bond funds, but the potential risks are not great, he added.

For residents of states with income taxes, investing in the state's bonds or a fund that holds

them exclusively makes more sense than a national muni bond fund, McGinley and Schatsky said.

Buying bond funds also gives investors access to professional money managers, observers pointed out.

A potential disadvantage to investing in municipal bonds or bond funds is that interest on some bonds may be subject to the alternative minimum tax, which is intended to ensure that wealthy people who are subject to special tax benefits still pay at least some taxes. In general, interest on private activity bonds, which finance things like stadiums, is subject the AMT.

Looking ahead to the end of 2005, McGuirk said that if interest rates continue to move up, "all fixed-income alternatives may have a challenging year," but "I don't know that municipals would stick out on the downside compared to anything else."

The table below shows a selection of single-state and national municipal bond funds ranked 5 Stars by Standard & Poor's. They have delivered among the highest returns within their specific category for the three-year period through Dec. 31, 2004, the period used to determine their S&P ranking.

-- Richard Diennor

SELECTED MUNICIPAL BOND FUNDS			
		Three-Year Total Return Through 12/31/04 (%)	Expense Ratio (%)
SINGLE-STATE FUNDS			
Alabama	Dupree Alabama Tax Free Income Fund (DUALX)	+7.0	0.40
Arizona	Eaton Vance Arizona Municipals/A (ETAZX)	+6.3	0.78
California	American Century California High Yield Municipal/Inv (BCHYX)	+7.2	0.53
California	Delaware Group:Tax Free California Fund/A (DVTAX)	+6.7	0.50
Colorado	Colorado BondShares (HICOX)	+6.1	0.61
Florida	Delaware Group:Tax Free Florida Fund/A (DVFAX)	+6.1	0.75
Florida	USAA Florida Tax Free Income Fund (UFLTX)	+6.7	0.64
Georgia	Eaton Vance Georgia Municipals/A (ETGAX)	+6.6	0.78
Hawaii	Hawaiian Tax Free Trust/Y (HULYX)	+5.6	0.52
Kentucky	Nuveen Kentucky Muni Bond Fund/A (FKYTX)	+6.3	0.84

Maryland	Nuveen Maryland Municipal Bond Fund/R (NMMDX)	+6.7	0.72
Massachusetts	Eaton Vance Massachusetts Municipals/A (ETMAX)	+6.4	0.80
Michigan	Nuveen Michigan Muni Bond Fund/R (NMMIX)	+6.5	0.66
Minnesota	Delaware Group:Tax Free Minnesota Fund/A (DEFFX)	+6.7	0.94
Mississippi	Dupree Mississippi Tax Free Income (DUMSX)	+7.2	0.40
Missouri	Eaton Vance Missouri Municipals/A (ETMOX)	+6.3	0.80
New York	Van Kampen New York Tax Free Income/A (VNYAX)	+6.9	0.76
New York	Delaware Group:Tax Free NY Fund/A (FTNYX)	+7.0	0.50
North Carolina	Nuveen North Carolina Muni Bond Fund/R (FCNRX)	+6.4	0.66
Ohio	Eaton Vance Ohio Municipals/A (ETOHX)	+6.8	0.80
Pennsylvania	Oppenheimer Pennsylvania Muni/A (OPATX)	+9.3	0.86
Pennsylvania	Federated PA Municipal Income Fund/A (PAMFX)	+6.4	0.75
Rhode Island	Eaton Vance Rhode Island Municipals/A (ETRIX)	+6.2	0.77
South Carolina	Eaton Vance South Carolina Municipals/A (EASCX)	+6.9	0.75
Tennessee	Nuveen Tennessee Muni Bond Fund/R (FTNRX)	+6.9	0.64
Utah	Tax Free Fund of Utah/Y (UTAYX)	+7.2	0.28
Virginia	Nuveen Virginia Muni Bond Fund/R (NMVAX)	+6.5	0.66
Wisconsin	Strong Wisconsin Tax Free Fund/Investor (SWFRX)	+6.6	0.30
NATIONAL FUNDS			
	Eaton Vance National Municipals/I (EIHMX)	+9.1	0.53
	Strong Municipal Bond Fund/Inv (SXFIX)	+7.8	0.80

SOURCE: Standard & Poor's. Data as of 12/31/04