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# Financial Briefs

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## What's Going on with Muni Bonds?

Traditionally, municipal bonds have been relatively safe investments. Over the past couple of years, however, that market has been extremely volatile, due to several factors:

**Credit ratings of bond insurers have been downgraded.** Historically, the municipal bond market has experienced very few defaults, making their credit quality relatively high. However, a significant portion of municipal bond investors are individuals who wanted added assurance that these investments were safe. Thus, in the late 1980s, insurance companies started issuing municipal bond insurance, which grew significantly in popularity. Recently, over 50% of all new municipal bonds obtained this insurance. The bond issuer purchases the insurance when the bonds are brought to market, with the insurance company committing to make timely payment of principal and interest in the event of the bond issuer's default. When the bonds are insured, the bond receives the same rating as the insurance company's rating.

Initially, insurance companies only provided insurance for municipal bonds, but then they started insuring taxable bonds as well. Some of that debt was tied to subprime mortgages, which caused problems for the insurance companies. Due to sizable losses from the subprime mortgage products, the ratings of

several insurance companies were downgraded, causing the downgrading of ratings of underlying municipal bonds. While the insurance companies received downgrades to their ratings due to losses on taxable insured bonds, that had a direct impact on municipal bonds. Typically, most of the insured bonds are investment-grade quality, even without the benefit of the insurance. However, many municipal bonds are trading based on the underlying rating of the bond or even lower, with no consideration given for the

insurance.

**Auctions for auction-rate bonds started to fail.** Auction-rate municipal bonds are long-term bonds with maturities of 10 to 30 years that have a floating interest rate. Every seven to 28 days, the bond underwriter holds an auction to reset the interest rate. The auction is a Dutch auction, which means that the interest rate is reset at the lowest rate that results in a sale of all the bonds. For issuers, they are basically issuing long-term

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## Answer These Questions First

**I**nvestments in bonds should be tailored to your investment objectives, risk tolerance, and other personal circumstances. Answering some fundamental questions will help you determine the role bonds should have in your portfolio:

**What are your overall investment objectives?** Investors committed to growth are looking for appreciation of capital with little concern for income, so bonds will have a minimal role in their portfolios. Total return investors want a balance of income and capital appreciation, so bonds will be more important in their portfolios. Income investors are looking for interest or dividend income with capital appreciation a secondary concern, so bonds will have a significant role

in their portfolios.

**What's your investment time frame?** When selecting bonds, you should consider when you will need the principal. Typically, yield increases as the maturity date lengthens, since you assume more risk by holding the bond for a longer time. Investors are often tempted to purchase bonds with long maturity dates to lock in higher yields. However, use that strategy with care. If you purchase a long-term bond and sell it before maturity, interest rate changes can significantly affect the bond's market value. Although you can't control interest rate changes, you can limit the effects of those changes by selecting bonds with maturity dates close to when you

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## Muni Bonds

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bonds at short-term rates. Investors receive a highly liquid bond that can be sold in an upcoming auction while earning interest rates slightly higher than money market rates. If there are not enough bids to complete the auction, the sellers are not able to sell their bonds, but they receive a predetermined penalty interest rate. Traditionally, if there were not enough buyers, the underwriter would step in and purchase the bonds. In January 2008, an auction failed because the underwriter would not step in. After that, auction failures became widespread, putting further pressure on municipal bonds.

**Many institutional investors sold their muni bonds.** Some institutional investors had to sell muni bonds because their ratings had dropped below allowable limits. Of more consequence, however, was the fact that billions of dollars of municipal bonds were sold by hedge funds to meet margin calls. Troubled banks, brokers, and insurance companies have also sold massive amounts of muni bonds to raise cash. The end result has been that there are more sellers than buyers, further depressing muni bond prices.

### What Is the Current Situation?

Historically, municipal bonds have yielded less than Treasury securities, because their income is exempt from federal income taxes and possibly state and local income taxes. The ratio of yields between the two securities has varied over time, depending on prevailing interest rates and tax rates. For individual investors, the attractiveness of municipal bonds is highly dependent on their individual tax bracket. Municipal bonds with maturities of 10 years or more have typically yielded between 80% and 90% of Treasury bond yields.

Over the past several months, it has not been uncommon to see ratios of 150% to 300%, meaning that the interest rates on municipal bonds are substantially higher than Treasury

## Using Bond Ladders to Manage Risk

A bond ladder is a portfolio of bonds of similar amounts that mature in several different years. For instance, a \$100,000 portfolio might consist of 10 different bonds of \$10,000 each, maturing in 10 consecutive years. When a bond matures, the principal is reinvested in another bond at the bond ladder's longest maturity date.

By spreading out maturity dates, the effects of interest rate changes are lessened. Since the bonds are held until maturity, changing interest rates doesn't result in a gain or loss from a sale. Bonds are maturing every year or two, so your principal is reinvested over a period of time instead of in one lump sum. If interest rates rise, you have principal coming due every year or so to reinvest at the higher rates. In a declining interest rate environment, you have some funds in longer-term bonds with higher interest rates. A bond

ladder keeps your bond portfolio invested in a range of maturity dates, evening out your interest income over time.

When designing a bond ladder, decide on an average maturity date, which could be five, 10, or even 20 years, depending on your financial needs. There should be enough "rungs" on the ladder for principal to mature every year or two. If the rungs mature in longer than two-year increments, you might miss interest rate changes. Consistently follow your plan by automatically reinvesting principal at the longest maturity date.

You can also set maturity dates in your ladder to coincide with a specific financial need. For instance, a bond ladder might mature in each of four consecutive years while your child is in college, allowing you to pay college costs with maturing principal. ■■■

securities, despite the income tax advantages. Currently, interest rates as of April 24, 2009, are:

Maturity	Treasury	Municipal Bond Yields			
	Yields	AAA	AA	A	BAA
1 year	0.50	0.97	1.25	1.88	2.47
5 years	1.96	2.12	2.40	3.06	3.71
10 years	3.03	3.23	3.60	4.33	5.00
20 years	3.99	4.66	5.05	5.76	6.46
30 years	3.89	5.04	5.42	6.16	6.87
% of Treasury yields					
1 year		194%	250%	376%	494%
5 years		108%	122%	156%	189%
10 years		107%	119%	143%	165%
20 years		117%	127%	144%	162%
30 years		130%	139%	158%	177%

Sources: *Federal Reserve Statistical Release*, April 27, 2009 and *The Bond Buyer*, April 27, 2009.

### Should You Invest in Municipal Bonds?

By historical measures, municipal bonds are very cheap compared to Treasury securities. On a tax-equivalent basis, assuming you are in the 25% tax bracket, a AAA-rated 10-year municipal bond is yielding 4.31% compared to 3.03% for a 10-year Treasury security. But does that mean that you should

purchase them?

The municipal bond market has become very volatile over the past couple of years, and no one knows when or even if it will return to normal levels. However, if the current situation corrects itself and the ratio between Treasuries and munis goes back to more traditional levels, purchasing now makes sense. Also, if income tax rates increase, current yields will be even more attractive on an after-tax basis.

If you purchase individual municipal bonds and hold them to maturity, you will not have to worry about changes in principal value. You will receive all of your principal when the bond matures. And at this point in time, the yields of even the highest quality municipal bonds are attractive. If you want to reduce your risk, you can purchase intermediate-term muni bonds with investment-grade credit ratings. If you'd like to discuss whether you should purchase municipal bonds, please call. ■■■

## Answer These Questions

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need your principal.

### What is your risk tolerance?

Typically, the higher a bond's return, the greater its risk. Thus, U.S. Treasury securities, which are considered one of the safest bonds, typically carry lower rates than municipal or corporate bonds. Make sure you understand the risks involved before purchasing a specific bond.

**Are you concerned with minimizing taxes?** Interest income from U.S. Treasury securities is exempt from state and local income taxes, but it is subject to federal income taxes. Interest income from municipal bonds is exempt from federal income taxes, and typically is exempt from state and local income taxes for residents in the issuing state. Interest income from corporate bonds is subject to federal and state income taxes. Investors in higher tax brackets typically find tax exemption of interest income more valuable. Be aware that any exemption from income taxes applies only to interest income. Capital gains from the sale of a bond are still subject to taxes.

**What variables should you consider before purchasing a bond?** Before you purchase a specific bond, make sure you fully understand its features and can answer the following questions:

- What is the bond's maturity?
- What is the bond's credit rating and is it insured?
- Does the bond have call provisions?
- What is the coupon rate?
- What is the bond's price?
- What is the yield to maturity?
- How is the bond's interest income taxed?

The role bonds play in your portfolio will depend on your answers to these questions. Please call if you'd like help evaluating your answers. ■■■

## Should You Consider Muni Bonds?

No investment, including municipal bonds, is appropriate for every investor. Before purchasing muni bonds, consider their advantages and disadvantages to see if they are appropriate for your portfolio.

Some of the advantages of muni bonds include:

- **Municipal bond interest income is generally exempt from federal, and sometimes state and local, income taxes.** Your marginal tax bracket is a major factor when deciding whether to invest in municipal bonds. Thus, you should compare a muni bond's yield to the after-tax yield of a comparable taxable bond. To do that, calculate the muni bond's taxable equivalent yield. If you're not investing in a municipal bond issued in your resident state, the calculation is: the taxable equivalent yield equals the tax-exempt interest rate, divided by one, minus your marginal tax bracket. For instance, if you are considering a municipal bond with a yield of 4.6% and you're in the 25% tax bracket, the taxable equivalent yield is 6.13% (4.6% divided by  $1 - 25\%$ ).
- **A wide variety of bond choices exist.** With over a million municipal bond issues outstanding, you can find bonds with all kinds of different characteristics.
- **Muni bonds typically have high credit ratings.** Municipal bond defaults are rare, but they do occur. Make sure to review the credit quality carefully before investing. About half of all muni bonds are insured, but with downgrades to the credit ratings of many of the bond insurers, it is important to look at the underlying rating of the bond issue itself. You may want

to stick with investment-grade ratings, which is an indication that the issuer is considered financially stable and unlikely to default.

Some disadvantages of municipal bonds include:

- **Muni bonds are not appropriate for all types of portfolios.** Munis should not be considered for individual retirement accounts (IRAs), 401(k) plans, or other tax-advantaged plans. Since municipal bond interest is already exempt from federal income taxes, you gain no further benefit by placing the bond inside a tax-advantaged vehicle. In fact, the interest income will ultimately be subject to ordinary income taxes when withdrawn.
- **Municipal bonds are callable.** Most muni bond issues have call provisions, which allow the issuer to redeem the bonds before maturity. The exact provisions, however, can differ significantly between bonds, so carefully review any provisions before purchasing a bond. While you can't prevent an issuer from exercising a call provision, you can purchase bonds with call provisions most favorable to you.
- **Muni bonds are still subject to some taxes.** While interest income is typically exempt from federal income taxes, selling a bond before maturity for a profit will result in a taxable gain. Also, some bonds pay interest income subject to the alternative minimum tax (AMT). State and local taxes must also be considered if the bond is not issued in your state of residence.

Please call if you'd like help deciding whether municipal bonds should comprise part of your portfolio. ■■■

## Business Data

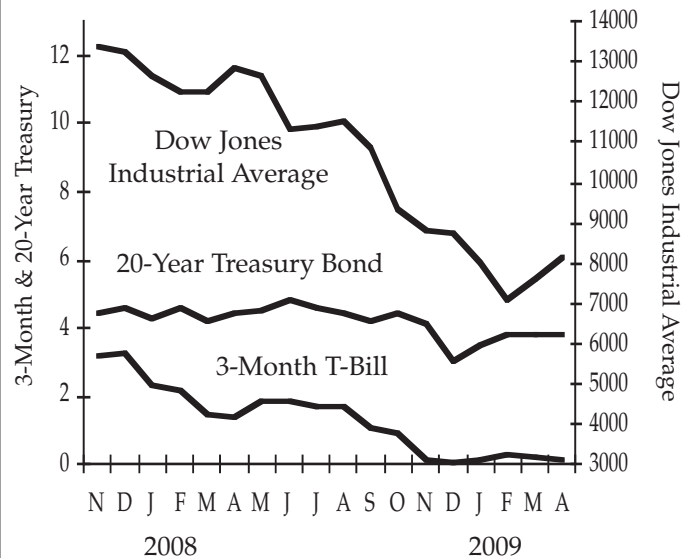


Indicator	Month-end				
	Feb-09	Mar-09	Apr-09	Dec-08	Apr-08
Prime rate	3.25	3.25	3.25	3.25	5.00
3-month T-bill yield	0.30	0.20	0.14	0.05	1.42
10-year T-note yield	2.75	2.75	2.87	2.26	3.67
20-year T-bond yield	3.80	3.78	3.80	3.04	4.44
Dow Jones Corp.	6.87	7.04	6.52	7.16	5.80
GDP (adj. annual rate)#	-0.50	-6.30	-6.10	-6.30	+0.90

Indicator	Month-end			% Change	
	Feb-09	Mar-09	Apr-09	YTD 12 Mon.	
Dow Jones Industrials	7062.93	7608.92	8168.12	-6.9%	-36.3%
Standard & Poor's 500	735.09	797.87	872.81	-3.4%	-37.0%
Nasdaq Composite	1377.84	1528.59	1717.30	8.9%	-28.8%
Gold	952.00	916.50	883.25	4.3%	1.4%
Unemployment rate@	7.60	8.10	8.50	18.1%	66.7%
Consumer price index@	211.10	212.20	212.70	1.2%	-0.4%
Index of leading ind.@	98.90	98.40	98.10	-1.0%	-3.7%

# — 3rd, 4th, 1st quarter @ — Jan, Feb, Mar  
Sources: Barron's, Wall Street Journal

## 18-Month Summary of Dow Jones Industrial Average, 3-Month T-Bill & 20-Year Treasury Bond Yield November 2007 to April 2009



## News and Announcements

### Get Your Finances in Order

You'll probably need significant investments to reach your financial goals. But before worrying about investing, you should get your finances in order. Consider these tips:

- **Have insurance in place for all major risks.** At a minimum, make sure you're adequately insured for life, health, disability, long-term care, homeowners, automobile, and personal liability.
- **Pay off your credit card debt.** If you're struggling to pay credit card debt, it's unlikely you'll have much additional cash for investing purposes. Also, you are unlikely to find better guaranteed returns than you get from paying off these debts. Since you don't get a tax deduction for interest payments on consumer debts, paying off a credit card balance with an 18% interest rate equates to a 24% pretax return for those in the 25% tax bracket.
- **Establish an emergency cash reserve.** This will give

you funds to deal with short-term emergencies, such as a temporary job loss, a short-term disability, a major home repair, or a large medical bill. How much you need in that reserve will depend on your age, health, job outlook, and ability to borrow.

- **Take advantage of matching contributions in your 401(k) plan.** Make sure to contribute enough to your 401(k) plan to take advantage of all employer matching contributions. When you don't contribute, you simply lose that money. Additionally, your contributions are made from pretax dollars, with earnings accumulating on a tax-deferred basis.
- **Establish financial goals based on your time horizon for investing.** Thoroughly evaluate your financial goals and how long it will take to reach them. The answers will significantly impact your investment decisions and will ensure that your investments are compatible with your financial goals.

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