

Reavans Newsletter May 2009 Issue

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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 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 securities, despite the income tax advantages.

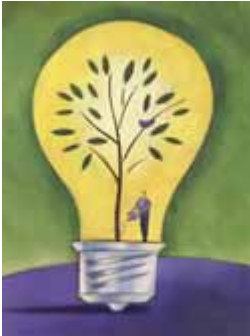
Should you invest in municipal bonds?

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 4.52% compared to 2.3% 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, then you do 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.



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 5.7% and you're in the 25% tax bracket, the taxable equivalent yield is 7.6% (5.7% divided by 1 - 25%).
- **A wide variety of bond choices exists.** 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 allows the issuer to redeem the bonds before maturity. The exact provisions, however, can differ significantly between bonds, so carefully review these 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 the state of your residence.



Will You Be Able to Work Longer?

Retiring at age 65 without working for the rest of your life is starting to look like a difficult proposition. It was already challenging due to longer life expectancies, uncertain Social Security benefits, declining pension benefits, unknown inflation rates, and low retirement savings. Then, most people's retirement savings decreased significantly over the past couple of years due to declining investment values and lower home prices. The prospect of funding a retirement that could span 30 years is looking very tough. The most common solution to the problem is to work longer than the current average retirement age of 63.

Today's workers are typically healthier and working at less physically demanding jobs than workers in prior generations, which makes working longer seem like an easy solution. But there are a number of factors that might not make that possible. First, approximately 15% to 20% of workers will not be healthy enough to remain in the work force longer (Source: Center for Retirement Research, September 2008). One study found that approximately half of those who retired early did so for health reasons (Source: *The McKinsey Quarterly*, November 2008). Second, since reduced Social Security benefits are available at age 62, a majority of workers claim benefits as soon as they are available. Finally, a significant portion of older workers no longer work for the same employer from middle age to retirement age. If workers want to remain in the work force until their late 60s, they may be forced to find a new job in their 50s or 60s.

A recent study looked at the percentage of men between the ages of 58 and 62 who were working for the same employer they had at age 50. In 1983, 75% of full-time male workers worked at the same employer, compared to only 50% in 2006 (Source: Center for Retirement Research, September 2008). These results were consistent across all educational levels. If workers are leaving voluntarily, they are probably moving to better jobs with better pay, which should mean they will stay employed longer. If workers are laid off or forced out of their jobs in their 50s or 60s, they are likely to take inferior jobs at lower pay, which may mean they are less likely to stay employed into their late 60s.

While it is difficult to determine why workers changed jobs, the wages of workers who switched jobs were approximately 75% of the wages of those with the same employer (Source: Center for Retirement Research, September 2008). Another study found that workers who left their jobs between the ages of 51 and 65 with at least 10 years of tenure did so due to retirement, layoffs, and voluntary and involuntary quits, with each factor accounting for one-third of the total (Source: Center for Retirement Research, September 2008).

Thus, while it is frequently suggested that workers should work longer before retiring, there are complicating factors that might make that difficult for all workers.



Rolling Over to a 401(k) Plan

If your 401(k) plan permits, you can roll over balances from a traditional individual retirement account (IRA), but not a Roth IRA, to a 401(k) plan. To qualify as a tax-free rollover, the balance must be rolled over to a 401(k) plan for the same person who owns the IRA, the balance must be rolled over within 60 days, and the maximum amount rolled over cannot exceed amounts that would be includible in gross income if not rolled over. Thus, contributions to nondeductible IRAs cannot be rolled over, but contributions to deductible IRAs and all earnings in both types of IRAs can be rolled over. Also, any required minimum distributions for the year cannot be rolled over.

Why would you want to roll over these balances to a 401(k) plan? By doing so, you can utilize one of these strategies:

- After rollover, you could withdraw any remaining funds in your traditional IRA free of taxes or penalties, since only nondeductible contributions would be left in the IRA. If you withdrew funds before the rollover, a pro-rata share of the withdrawal would be subject to income taxes and possibly the 10% federal tax penalty.
- If your income is under \$100,000 in 2009, you could convert the remaining funds in your traditional IRA to a Roth IRA with no tax cost. Again, since the IRA only contains nondeductible contributions, there would be no income taxes associated with the conversion. Also keep in mind that starting in 2010, there will be no income limitation for Roth IRA conversions.
- Once the funds are rolled over to the 401(k) plan, you could withdraw the funds without penalty at age 55 if your employment is terminated, rather than waiting until age 59 1/2 to withdraw the funds without penalty from the IRA. If permitted by the 401(k) plan, loans can also be taken to gain access to the funds.



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 debts.** If you're struggling to pay credit card debts, 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% pre-tax 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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FR2009-0128-0079