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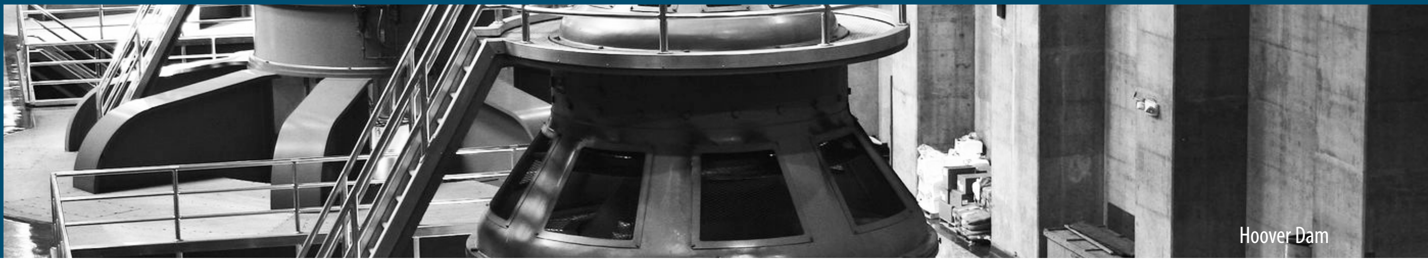

Tailored Municipal Bond Portfolios vs. Mutual Funds

For investors looking to put relatively small amounts of capital to work in the municipal bond market, mutual funds can provide professional management and valuable diversification. However, those with $2 million or more to invest stand a better chance of maximizing long-term after-tax returns by opting for the flexibility and customization of a segregated municipal bond portfolio.

A comprehensive report on this subject could fill an entire book, as there are numerous topics for high net worth individuals to consider. The objective here, however, is only to shed light on five key principles that have historically been under disclosed to prospective municipal bond investors.

They include:

1) Reaping the benefits of counter-cyclical investing

2) Maintaining an appropriate level of credit risk

3) Maximizing tax efficiency

4) Opportunities presented by smaller blocks of bonds

5) Preserving the ability to utilize the maturity feature

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Counter-cyclical Investing

Counter-cyclical investing in a tailored municipal bond portfolio enables an investor to stay ahead of the game and avoid the fate of the mutual fund herd. If funds are deployed in actual bonds when interest rates are high and the rates subsequently decline, attractive yields are locked in and the investor can enjoy watching their bonds appreciate. However, with a mutual fund investment, the drop in interest rates will continuously dilute the weighted average cost yield. This is because as more money pours into the fund, additional bonds must be acquired at ever-lower yields. This reduces the average return for all participants, who have no say in the matter.

Conversely, if rates are moving up, an investor with a tailored municipal portfolio can take advantage of buying opportunities when they emerge. Mutual funds may well be a seller of bonds instead as share redemptions are met. Unfortunately, if the investor held mutual fund shares and tried to sell in hopes of buying another fund, this would not likely help as most funds will suffer the same fate at the same time. Sitting in cash is expensive and you may miss the market opportunity altogether.

Credit Risk

One should be investing in municipal bonds, not trading or speculating. The mission is to optimize long-term, after-tax, risk-adjusted performance. Municipal bonds do an excellent job of preserving capital, providing liquidity and generating tax-free income. Along with cash and cash equivalents, they serve as the foundation of your investment pyramid. Taking greater risks, including credit risk, should be reserved for allocations to other asset classes, higher up the pyramid, that are designed for superior growth.

Performance unadjusted for risk can be very misleading. It seems illogical that large municipal mutual funds armed with sophisticated credit research teams invariably show up as major holders of highly-distressed positions: Detroit, Puerto Rico, Stockton, etc. The simple truth is that if they need to buy higher-yielding product in bulk to get a leg up on the competition, chasing after distressed bonds from large issuers is usually the only viable option. Undervalued positions of investment grade bonds are almost always smaller in size, usually under $250,000. Acquiring high yielding bonds for investors should be a matter of greater reward for greater effort, not greater reward for greater risk.

Tax Efficiency

There are a number of scenarios where a tailored municipal bond portfolio is preferable to owning a mutual fund from a tax perspective. Taking gains on the sale of municipal bonds requires careful analysis. Simply put, it involves giving up a superior tax-free return and incurring a tax liability in the process. An investor with a tailored municipal bond portfolio can choose when to take gains, unlike with a mutual fund position. Most people know someone who has received a tax bill from a mutual fund in a year when it actually lost money. The fund may have sold to buy more attractive assets or meet redemptions. This may have been contrary to the investors' best interest, but unfortunately they don't have a say.

An investor can liquidate an underwater municipal bond position in a tailored portfolio, creating a capital loss to offset a tax liability from a gain realized elsewhere. The proceeds from the sale can also be reinvested in municipal bonds with higher yields, raising the average yield on the portfolio. This is a win win, and can be repeated if interest rates continue to rise. An individual

"Nothing in life is to be feared. It is only to be understood." Marie Skodowska-Curie

bond position with a loss cannot be cherry picked from the mutual fund.

With a tailored municipal bond portfolio, an investor can exercise discretion over swapping out existing positions, particularly those with call provisions. In certain instances, a block of bonds may be near a point where further price appreciation is limited due to the proximity to a call. A mutual fund manager would be tempted to swap it for a new block that has plenty of appreciation potential. If, however, the existing bonds stand a very good chance of remaining outstanding until maturity, despite the call, and offer a much higher stream of tax-free income than the new bonds, the portfolio's after-tax, long-term performance may be substantially higher without the swap. This type of call analysis is much more likely with a tailored approach.

Tailored municipal bond portfolios can be state specific, as can mutual funds. But what if an investor moves, perhaps to a smaller state with fewer investment options? Or they might just want to purchase an out-of-state block of bonds simply because it is a good credit and the yield it offers is superior even after being taxed in their state. This is possible with a tailored portfolio, but unlikely to happen in a state-specific mutual fund.

Small Blocks of Bonds

Smaller-sized blocks can be of great help to a municipal bond investor as they are more likely to trade below their intrinsic value than more efficiently priced large blocks. Tailored portfolios are nimble and able to take advantage of such opportunities to buy bonds at compelling yields. Successful mutual funds, on the other hand, are typically large and limited in their range of investment options because small blocks simply won't move the needle no matter how cheaply they can be purchased. These funds need to buy multi-million dollar positions and find themselves overly dependent on the primary (new issue) market where bonds tend to be priced at or through the offered side of the market. It would be impossible for them to stay fully invested by buying 100 or 200 bond blocks in the secondary market.


San Francisco City Hall

"Sunlight Is the Best Disinfectant." U.S. Supreme Court Justice Louis Brandeis

Fixed Maturities

While virtually all actual municipal debt has a specific maturity date, an open-ended municipal bond mutual fund does not. Participants own shares in the fund that do not mature. Exiting the investment requires selling the shares. If interest rates rise and an investor holds shares in a mutual fund with sub-investment grade credits, the probability of default may preclude the fund from waiting for the bonds to mature and force the sale at a very distressed price. Alternatively, an investor with a tailored portfolio always retains the ability to utilize the maturity feature of any of their bonds. If a significant rise in interest rates leads to a loss on an investment grade bond, it is possible and perhaps desirable to sit on the position until maturity if a reinvestment would take too long to make up the loss a sale would produce.

Conclusion

A tailored municipal bond portfolio affords greater opportunities and flexibility for high net worth investors. Specific strategies and tactics can be continuously applied to meet the unique portfolio requirements of each investor. The one-size-fits-all approach of municipal bond mutual funds, while providing a viable option for smaller investors, has as its primary virtue, efficiencies of scale that benefit those running the fund, not the investors. While managing tailored individual portfolios is a great deal more work, the many advantages produced accrue directly to the investor.

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Charles W. Fish is the Chief Executive Officer and Chief Investment Officer of Charles Fish Investments, Inc. Skip, as his friends know him, is a nationally recognized expert in the field of municipal securities, where he has worked continuously since l970. Before founding CFI in 1984, Skip managed the Municipal Bond Department of Crocker National Bank, with offices in New York, San Francisco, and Los Angeles. That was followed by four years with the brokerage firm of Smith Barney Harris Upham. Over the years he acquired an in-depth knowledge of underwriting, credit analysis, portfolio management, trading, and sales of municipal bonds.

Skip has served on numerous boards during his career, including the Municipal Securities Rulemaking Board (MSRB), created by an Act of Congress in 1975 to establish the rules governing the conduct of the thousands of municipal securities dealers across the United States. Skip was elected Chairman of this Board and during his tenure was a leading proponent of the rules that were adopted to curb abuses in political contributions, and greatly expanded the disclosure policies of municipal bond issuers.

Skip has been called to testify before Congress on two occasions: once representing the municipal securities industry as a whole and once representing municipal bond investors in the aftermath of Orange County, California's bankruptcy filing.

Skip earned a Bachelor's Degree from Utah State University before serving as an officer in the United States Marine Corps from 1965 to 1970.

To learn more about CFI and meet the team visit charlesfishinvestments.com or call 949-296-3970.