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WSJ: Beware the Muni-Bond Illusion.

When reviewing a new client's portfolio, I am often told that my recommendations need to include keeping the client's municipal-bond manager, as they are earning over 4% tax-free. By comparison, the Vanguard Intermediate-Term Tax-Exempt Fund's Admiral shares are earning only 1.64%.

To the client, it appears the manager is earning his fee by tripling the return, but appearances can be deceiving.

The illusion that one is earning this return can be illustrated by taking a look at one particular bond held by one of my clients: a California State Public Lease Revenue bond paying a handsome 4.5% coupon. It matures in just under four years, and the manager recently bought the bond at $112, or a 12% premium to the par value. The statement showed the bond yielding 4%, which is calculated by taking the $4.50 annual payment per $100 par and dividing by the $112 purchase price.

Still not too shabby.

Unfortunately, for those buying the bond at a premium, bonds mature at par. This means the investor gets back only $100 for every $112 invested. Simply put, the investor is losing $12 over the remaining four-year life of this muni, or roughly $3.00 per year – 2.7% of the initial investment. So now the 4% yield is reduced to 1.3% after taking into account what is known as the "amortization" of the premium.

We're not done yet. The manager charges this investor 1% annually for holding this and every other bond, reducing the 1.3% to a measly 0.3% annualized return. That's what this investor will net by holding this bond until maturity.

Suddenly, the 1.64% yield of the low-cost diversified muni-bond fund is looking pretty good compared to the 0.3% this investor is netting after buying the bond at a hefty premium and paying a manager 1%.

The numbers in this example are a bit overly simplified to illustrate the point. The more-precise numbers are actually a bit worse for this investor. It's also important to note that this illusion is just as prevalent and valid for taxable bonds as well.

That's why I like low-cost diversified bond funds. Investors end up with a higher actual yield, much more diversification and higher liquidity as well. You just have to give up the illusion.

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