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What Do Muni Bonds Have To Do With Medicare? Here's Why You Should Care.

It's that time of year again. No, I don't mean the holidays. It's that window in time when those who just turned 65 can sign up for Medicare.

You're probably asking why a bond manager is writing about Medicare and what this has to do with anything. Simple. The law requires some people to pay higher Medicare premiums than others. Simply stated, this is the government's way of saying that Medicare is means tested. Those who earn more, pay more. Tax-free income from municipal bonds is included in your modified adjusted gross income.

Here's the rub. You may own a large municipal bond portfolio of all high coupon munis: maybe 5.50%, 5.00%, perhaps some 4.00% coupons. If you purchased bonds over the last four years with maturities 12 years or less, you paid high premium prices for each. Your actual yield based on cost is most likely one-half that of your coupon. However, your brokerage firm reports the gross coupon income on your Form 1099, which is also reported to the IRS, and then reported to the Social Security Administration for use in means testing your Medicare premiums. By definition this overstates your income, thus possibly placing you in a higher Medicare means testing category than is appropriate.

The bummer here is that if your muni portfolio is large enough and populated with high coupon bonds, the gross income grotesquely overstates what you are actually earning. You should care because it may increase your Medicare premiums. This is due to the difference between coupon cash flow versus real yield based on cost.

This coupon tragedy is much more prevalent in Muniland as opposed to corporate bonds. That's because when a state, city, county or municipality comes to market with a new issue there usually is a reverse inquiry. That is, several municipal bond fund managers may be queried as to what structure they may be interested in having. All high coupons? Current coupons? Zero coupons? From what I understand of the process the underwriters take that information under advisement then decide with the issuers the best structure.

Take a look at Illinois—the most dysfunctional state government. To help pay down their $16 billion in unpaid bills over the past two years the state issued $4.5 billion bonds. The 5.00% municipal General Obligation bonds due November 1, 2022 was one maturity size. This portion of the 2022 maturity size represented $500 million of the $4.5 billion. The dollar price at the new issue was 108.465, or $1084.65 per bond yielding 3.15% to maturity.

This means at maturity you'll hopefully get back $1,000 face value for every bond. Do the math. The state immediately took in a premium of $84.65 per bond equaling $42,325,000 more than it will pay at maturity while paying a 5% coupon rather than the 3.15% yield to investors based on the bond's cost.

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