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Tips for Talking Munis with Clients as Rate Hike Looms.

(Reuters) – Municipal bonds remain a favorite of financial advisers and tax-conscious clients, even though they could be vulnerable to interest rate hikes later this year.

Munis – notes issued by states, cities, and counties to finance infrastructure and other projects – can offer a near-guaranteed return to clients, with slightly higher yields than treasuries, investment advisers say. They also offer federal, and potentially state and city, tax benefits.

Kevin Ashworth, an adviser and investment director at EP Wealth Advisors in Torrance, California, helps to generate tax-free income for clients through federally tax-exempt municipal bond mutual funds, or local general obligation bonds.

Many clients are now eager to sell fixed-income investments before rates increase, Ashworth said.

But he tells them they "can't abandon fixed income altogether," and stresses the benefits of munis. "We view municipals as the safe asset for clients."

Ron Weiner, president and founder of RDM Financial Group in Westport, Conn., says advisers who recommend muni bonds shouldn't shortcut the calculations needed to see whether an individual client will reap worthy after-tax returns.

"You have to do the math of the individual tax bracket," he said, noting that clients sometimes end up with a higher after-tax yield if they forgo muni tax breaks and pay income taxes on corporate bond interest.

Even when owning an individual municipal bond makes sense, it can be challenging for a client to find the right vehicle, given strong demand and relatively few issues, advisers say.

NOT SEEKING THE 'HOME RUNS'

Mutual funds can offer a wider mix of muni bonds, said Jay Sommariva, senior portfolio manager of fixed income at Fort Pitt Capital Group in Pittsburgh.

But he recommends mostly high-grade bonds with good track records issued by local cities and school districts, that offer the greatest tax benefits for area clients.

"We're not looking for the home runs," Sommariva said. He focuses, instead, on quality and a nominal coupon that provides a reasonable spread over Treasuries, and a return.

Clients may expect more of a return from municipal bonds than they perhaps should, after a year in which the securities did particularly well. The Standard & Poor's Municipal Bond Index, for example, returned over 9 percent in 2014, as the risk of defaults in Detroit and other cities faded and interest rates and yields were low.

Advisers must help clients realize that outsized returns are not the point of municipals, or any fixed-income investment.

A fixed-income portfolio is supposed to produce reliable income, said Brian Battle, analytics group director at Performance Trust Capital Partners in Chicago.

Battle believes strongly in the tax and near-guaranteed returns offered by municipals. He tells clients the municipal sector is a high quality one, and "unique to the U.S."

Educating clients about the purpose of fixed-income and municipals can be difficult right now, but it must be done, said Weiner of RDM Financial Group.

"We're settling clients into the idea that bonds are for safety," he said.

BY HILARY JOHNSON

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(The author is a Reuters columnist. The opinions expressed are her own.)

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