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How Muni Bonds 'Yield' 4% in a 2% World.

If you see fat 4% "yields" for the municipal bonds in your brokerage-account statement, don't believe them.

Overstating the expected income on municipal bonds in brokerage or advisory accounts is one of the most pervasive and persistent ways the financial industry fools the investing public. It was going on when I was a cub bond-market reporter in 1988, and it's still going strong. It's high time investors fought back.

The Barclays Municipal Bond Index, a measure of the market for these tax-free bonds issued by state and local authorities, yields 2.2%. Even the Vanguard Long-Term Tax-Exempt Fund, which specializes in municipal debt maturing many years in the future, yields only 2.3%.

So how can so many brokers and financial advisers be such astute bond-pickers that they can claim to be earning yields of 4% and up without jeopardizing your capital?

They can't. Those yields are an illusion.

You would never know it from looking at your account statement, however. Brokers and financial advisers are able to report the yield on many municipal bonds without adjusting for an inevitable decline in their price—thus significantly overstating the income you will earn.

To understand why, note that in a world of low interest rates, bonds are often issued at a "premium over par," or initial price greater than $100 per $100 of par or principal value. But they almost always mature—or are "called," if the issuer buys them back before maturity—at $100.

Imagine this streamlined example: You pay $110 for a bond that pays 4% interest and matures four years from now. Each year, you will earn $4 in interest on each $100 you have invested in the bond. And when it matures, you will get $100 back—not $110.

So you will earn $16 in simple interest but lose $10 on your principal at maturity, a total gain of $6. Your adjusted return is nowhere near 4% per year; it's approximately 1.5% ($6 divided by four).

Under federal accounting and tax rules, a mutual fund or exchange-traded fund would be required to report the yield on that bond as approximately 1.5%. A broker or financial adviser, operating under rules from an industry self-regulator called the Municipal Securities Rulemaking Board, can report it at 3.6% ($4 in income divided by $110). Your brokerage or advisory account statement excludes future losses (or gains) on the bond's principal when it reports yield. It's simply an incomplete picture of your money.

Alex Alimanestianu is the retired chief executive of Town Sports International Holdings, an operator of fitness clubs. In 2007, a year after the company sold stock to the public, he invested in a portfolio of municipal bonds through his brokerage account at Credit Suisse CSGN.VX -0.02%. Last year, Mr. Alimanestianu realized that the "estimated yield" on his account statements was overstating what he would earn from his munis.

Oddly, the broker disclosed the failings of its calculation. In a footnote, Mr. Alimanestianu's account statements explained that "return of principal may be included in the figures for certain securities, thereby overstating them." Morgan Stanley MS -1.70%, Charles Schwab SCHW -1.55% and many other firms make similar disclaimers.

Mr. Alimanestianu says the yields reported to him by Credit Suisse were "deceptive" because "part of what the bonds were yielding was my own money, the premium that I paid above what they're going to pay me back." He has since moved his municipal-bond holdings to Vanguard Group.

A Credit Suisse spokeswoman declined to comment.

A muni-bond portfolio manager says calculating yield this way is "a silly, antiquated, misleading measure that isn't good for anything except putting the bonds in an unfairly good light." While we were on the phone, he looked at sample account statements from several brokerage firms and found that none of them adjust yield for return of principal. "I didn't even realize they all do it this way until you asked," he said.

Should this change? "I don't think [such disclosure] is misleading," says John Bagley, head of market structure at the Municipal Securities Rulemaking Board. "But could it be confusing to some investors? Yes, I think that's possible."

He adds, "we've done some education on this topic, but it's something we may potentially look into more to improve transparency."

In the meantime, ask your broker or adviser to tell you the "yield to worst" on your munis, adjusted for return of principal. If she can't or won't tell you, maybe you need a new adviser.

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