Municipal Advisor

Information and Strategies for Municipal Bond Investors

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Is Your Municipal Bond Portfolio Structured Appropriately?

One of the advantages of owning a portfolio of individual municipal bonds is that each portfolio decision can be evaluated based on how appropriate it is for you. This can be especially important when contemplating portfolio moves that have the potential to impact your tax situation.

While municipal bond investors are accustomed to investing in an effort to maximize their tax-free income, they frequently overlook the potential benefits of active portfolio management strategies because they think of themselves as "buy and hold" investors.

However, there is a difference between a "buy and hold" investor and a "buy and hold" investment, because the characteristics of your portfolio change as your bonds approach maturity—potentially affecting the appropriateness of any security you may own. While it is sensible to be reluctant to consider changing your portfolio, any investment should be retained only as long as it is appropriate for *you*.

> "Although buy-and-hold is a realistic option for investors who buy equities, it is an act of wanton imprudence for investors in debt securities. Ultimately, of course, a debt security reverts to cash, and thereafter earns nothing for its owner. Well before the maturity date, however, its entire pattern of market behavior changes with the passage of time. This means that active management of fixed income securities is an inescapable responsibility."
>
> Peter L. Bernstein, President of Peter L. Bernstein, Inc. and Consulting Editor of *The Journal of Portfolio Management*. From the foreword to the first and second editions of *The Handbook of Fixed Income Securities.*

Portfolio Returns

When there is an opportunity to improve your overall portfolio return by appropriately changing your security selection, you should consider doing so. (You may also want to read "What is Performance" in the May, 2003 edition of *Municipal Advisor*.)

Can you control your overall portfolio return? What is overall portfolio return? For an individual investor, a practical definition would be how much money you earn on your investment—after accounting for losses, expenses and taxes. In other words:

Return = (Earnings – losses + gains – expenses – taxes) / Investment

There are several ways to improve your Return:

- Increase Earnings. (However, seeking higher earnings usually means taking on more risk, which may not always be appropriate.)
- Increase Gains. (When and how you realize your gains may increase taxes.)
- Decrease Losses. (Seeking to avoid losses may mean avoiding risk—which may reduce earnings. Depending on your situation, realizing a loss might provide a tax benefit.)
- Reduce Expenses.
- Reduce Taxes.

Given current market conditions, there are several strategies that you may wish to consider that could potentially improve your return:

- Municipal Bond Tax Loss Swaps—may be able to offset gains, maintain earnings, and reduce taxes.
- Short Maturity Extension Swaps—may be able to realize gains while maintaining or increasing earnings.

In a bond swap, an investor sells one or more bonds while simultaneously buying one or more different bonds. Swaps are a commonly used technique, employed to adjust a portfolio while remaining fully invested. (Bond swaps should not be confused with swap contracts, which are securities that derive their value from an underlying security or index.)

Municipal bond swaps can be executed for a number of reasons, including: to lock in a long-term capital gain or establish a loss for tax purposes; to adjust portfolio characteristics such as average maturity, cash flow, etc.; or to take advantage of changes in market conditions, credit quality, etc.

Municipal Bond Tax-Loss Swaps

In a municipal bond tax-loss swap, a municipal bond that has declined in value is sold below its adjusted cost basis and a similar—but not substantially identical—municipal bond is purchased (please refer to The Wash Sale Rule, below). Municipal bond swaps are frequently easier to accomplish than equity swaps because of the availability in the market of bonds that have similar characteristics to the bonds sold, yet are not "substantially identical."

If you are holding a municipal bond whose market value is lower than your adjusted cost, you may be able to realize that capital loss and use it to offset a capital gain—reducing your overall taxes and increasing your Return (without compromising your original portfolio objectives).

A tax-loss swap takes advantage of the fluctuations in interest rates by selling bonds that were bought at lower yields than are presently available and therefore realizing long-term capital losses that can be used to offset long-term capital gains.

Investors who are reluctant to realize gains in their portfolios because of the tax consequences may be able to offset those gains with losses from their bond portfolio.

Capital Gains and Losses

Capital losses can be valuable since they can be used to offset capital gains and even ordinary income.

Capital gains or losses can be summarized as follows:

- Short term and long-term gains and losses are combined, resulting in net short-term or net long-term gains and losses.
- Net short-term losses offset net long-term gains and the net gains remaining, if any, are "net capital gains" which qualify for the 15% tax rate.
- Net long-term losses offset net short-term gains and if there are gains remaining they are taxed at ordinary income rates.
- If capital losses exceed capital gains in total, the excess can offset up to $3000 of ordinary income.
- The remaining excess, if any, is a "net capital loss" which is available for carryover to subsequent years and treated as if they had been incurred in that year.

The net-short gains would be taxed at ordinary rates, the net long-term gain would be taxed at the maximum 15% rate.

Anyone who owns bonds that are selling below their adjusted purchase price and who also has capital gains or other income that could be partially or fully offset by a tax loss, can potentially benefit from tax swapping. Because a bond swap involves selling and simultaneously buying bonds, executing a tax loss swap may provide the occasion to improve other portfolio characteristics as well by buying bonds with characteristics that are different from the bonds that are sold.

The Wash Sale Rule

Investors considering a tax loss swap must be careful to avoid a wash sale. According to the Internal Revenue Service, "a wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you buy substantially identical stock or securities." You would also have a wash sale if you sell securities and your spouse or a trust or corporation you control buys substantially identical securities. (See Internal Revenue Service Publication 550, *Investment Income and Expenses*.)

Municipal bond investors can avoid a wash sale by purchasing bonds of a different issuer. If the same issuer's bonds are purchased, there must be a "substantial difference" in both the coupon and the maturity. "Substantially identical" is not defined in the Internal Revenue Code or regulations. However, past experience has shown that decisive factors include risk, identity of the issuer, the security's coupon rate, redemption provisions and possible maturity date.

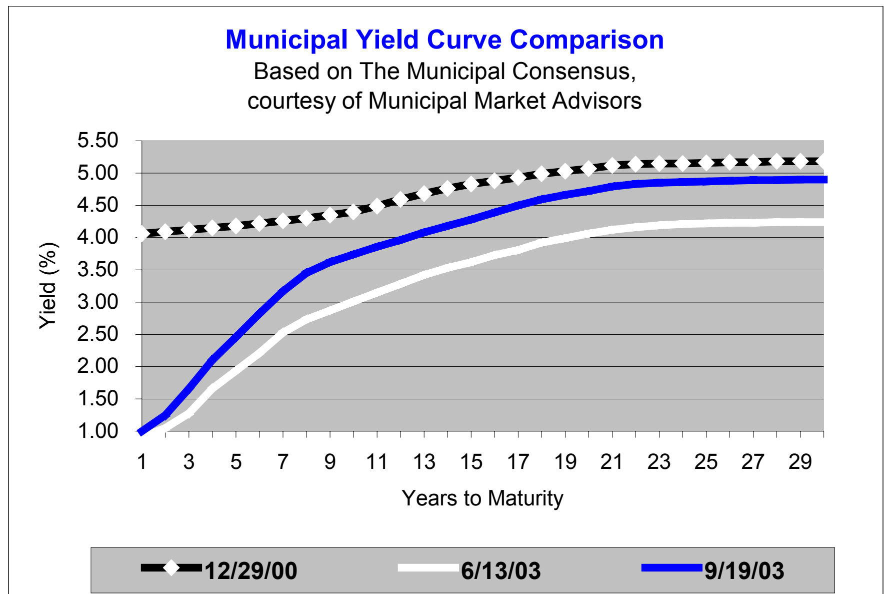
Please remember that we do not provide tax advice. We recommend that you speak with your tax advisor for specifics on your personal tax situation prior to implementing a bond swap strategy.

Each municipal bond swap should be carefully reviewed for its particular facts.

Short Maturity Extension Swaps

As shown in the graph, short-term rates are much lower now then they were just prior to the first of the thirteen Federal Reserve rate cuts. (The first rate cut in the most recent cycle occurred on January 3, 2001, when the Fed Funds target was cut from 6.50% to 6.00%. The most recent cut was on June 25, 2003, when the target rate was cut from 1.25% to 1.00%.) Longer-term yields, meanwhile, are much closer to where rates were at year-end 2000.

Consequently, investors may have large unrealized gains in their short maturity bonds, while longer maturity holdings may be much closer to their original cost.



Because it is the short end of the yield curve which has shown the greatest decline in yields, when the Federal Reserve begins to raise rates, it is likely that it will again be the short end of the yield curve that will be impacted the most—this time to higher yields (and lower prices). (Maury Harris, Chief Economist currently expects that the first rate hike from the Federal reserve will not occur until the third quarter of 2004. *US Economic Perspectives*, September 19, 2003.)

Market Premium May Decline

Even without a change in the markets, as a bond approaches its maturity date, the market value will get closer to the maturity value—that is, Par, or 100.000. The shorter the time span between now and maturity, the faster the change in the market value. If rates are rising, that will accelerate the decline of the market value.

Investors with meaningful unrealized gains on short-maturity bonds may wish to swap out of those bonds and into intermediate maturity bonds with similar (or higher) coupon rates. If the unrealized gains are large enough, you may be able to reinvest in a larger block size—thus maintaining income while increasing the par amount of the portfolio. (Your Return may be improved even more if you also have capital losses that can be used to offset the gains realized on the sale of your short-term positions.)

Example

One client recently completed a swap that realized a gain, consolidated smaller positions into larger block size and increased income. Had this investor waited for his bonds to mature, he would have received almost $38,000 less than he did by selling now. This is only an example, and may not be feasible or appropriate for other investors. Keep in mind that extending into longer maturity bonds can increase interest rate risk, so any proposed transaction in your portfolio should be evaluated based on your own specific objectives. Because UBS Financial Services Inc. does not provide tax advice, you should consult your personal tax advisor for specific advice prior to swapping.

	Sell	Buy	Change
Par Amount	615M	615M	Unchanged
Average Coupon	4.66%	5.00%	+0.33%
Projected Annual Income	$28,678.50	$30,750.00	+$2,072.50
Estimated Market Value	$652,972.50	$649,459,50	+$3,513.00
Average Maturity (Years)	3.44	14.94	+11.51
Profit / (Loss)	$37,972.50		

This example is provided for illustration purposes only and is not intended to represent a specific investment of portfolio.

Conclusion: Identifying Swap Opportunities

Tax Loss Swaps: Any bond with an unrealized loss is a potential tax loss swap candidate. However, bond characteristics, market conditions, the structure of your portfolio and your situation will all affect the determination of whether a tax loss swap is appropriate for you. Review your portfolio holdings for unrealized losses.

Short Maturity Extension Swaps: Review your portfolio for shorter-maturity bonds (approximately 2 to 7 years) for unrealized gains. Watch especially for long-term bonds that which have become pre-refunded since you acquired them, as their effective maturity will be much shorter than what you originally bought.

How to Appropriately Invest in Municipal Bonds

If you are going to invest in municipal bonds, should you invest directly or by buying shares in a mutual fund? Should you retain decision-making authority, or should you engage a portfolio manager? The answers to those questions will depend on your circumstances. However, what follows is a brief overview of some of the points to consider when making decisions.

How to Buy Municipal Bonds: Municipal bonds can be purchased directly—as a portfolio, or indirectly—by buying stock (common or preferred) in a special purpose investment company (a mutual fund):

Buying Stock in a Mutual Fund	Build a Portfolio of Individual Municipal Bonds
Advantages: ■ Total Return investment in a bond-like vehicle for smaller investments ■ Diversification ■ Professional management ■ May be appropriate for smaller initial investments ■ Dividend reinvestment **Disadvantages:** ■ No fixed maturity date (Full return of principal contingent upon prevailing market conditions) ■ Amount of income not fixed ■ No control over security selection ("One size fits all") *For more complete information about specific mutual funds including charges, expenses and risk factors, please review the fund's prospectus. Clients should read it carefully before investing or sending money.*	**Advantages:** ■ Can be tailored to each client's specific objectives ■ Permits development of complex and sophisticated strategies suitable for high net worth clients ■ Can be built to reflect market outlook ■ Can be adjusted to reflect changes in outlook or objectives **Disadvantages:** ■ May require a larger initial portfolio size ■ May require greater level of involvement (time) and diligence ■ May be more difficult to be as diversified as in a fund

Investor Objectives: For investors with a portfolio of individual bonds, objectives fall into two major categories:

Stable Defined Income (Current Income)	**Stable Market Value** (Capital Preservation)
■ Willing to accept fluctuation in market value in exchange for a more predictable income flow. Most often individual investors who are living on their investment income.	■ Willing to accept greater uncertainty in income in exchange for greater stability in market value. ■ As a trade-off, these investors may seek to maximize their return (coupon income plus or minus capital gain—also referred to as total return investing), recognizing that their return will fluctuate from period-to-period. ■ Individual investors with excess wealth (more than is necessary to provide their desired level of income) often allocate a portion of their excess capital to total return investing, seeking to capture potential market opportunities while maintaining their desired level of income.

Control: When should an investor consider hiring a portfolio manager? Because of the cost involved, portfolio size is certainly an important consideration. In some situations, it may simply be uneconomic to hire a portfolio manager. Investors who are seeking to have a portfolio that is built and managed for their specific circumstances can do so by retaining control of the investment decisions, or can delegate those decisions by hiring a portfolio manager. The fundamental determinants of whether or not to hire a manager are the cost involved and the degree to which the investor wants to be involved in the portfolio management decisions.

For additional information, please contact your Financial Advisor.

UBS Financial Services Inc.

Patrick Luby, National Municipal Marketing Group, September 22, 2003.
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