

Intelligent Investing

## Buy Muni Bonds Over Stocks

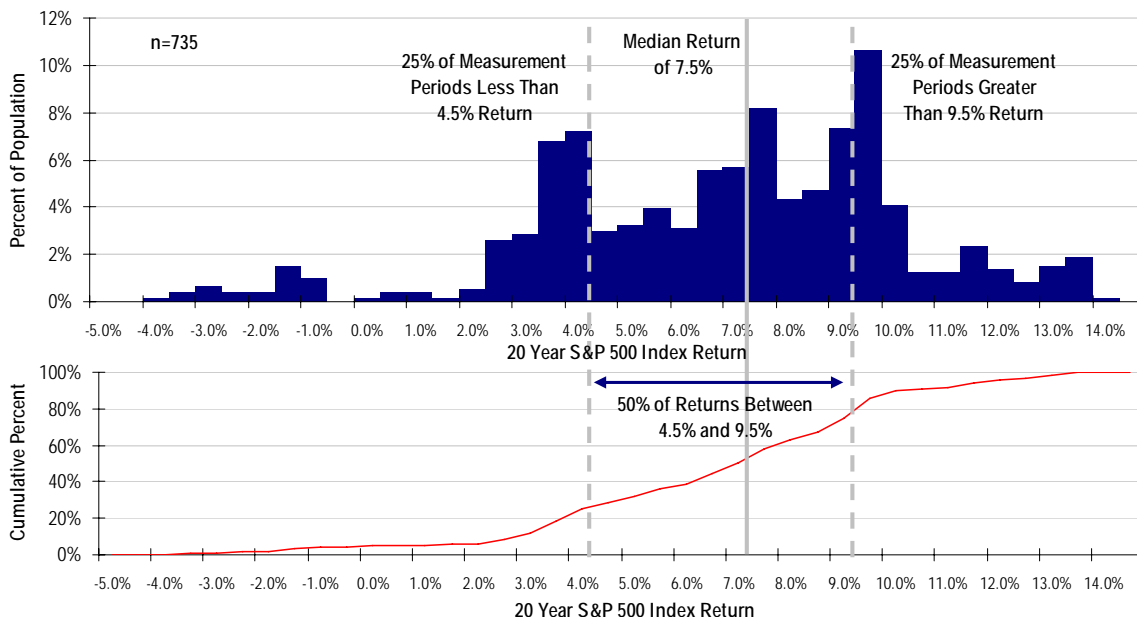
Michael Toporek 08.17.09, 6:00 PM ET

Now that the equity markets have recovered from their near death experience in March and returned to some sort of equilibrium, it is a good time to reassess asset allocation and recalibrate our roller coaster expectations. With that, we pose the question: Mirror, mirror on the wall, which is the fairest investment of them all (for those with a 20-year holding period): long-term municipal bonds or equities?

First, let's calibrate expectations. What is a reasonable return to expect from the S&P 500 for a 20-year holding period? When we asked our clients, our unscientific study gave us two distinct answers. Older clients (65 years and older) expect a return of 7% to 8%, while our younger clients (30 to 45 years old) said 10% to 12%.

In this case, wisdom and life experience pays off. For the 735 rolling monthly 20-year periods from 1950 to 2008, the S&P 500 had a median return of 7.5%. About half the periods returned between 4.5% and 9.5%. Looking at this distribution another way, double 7.5% to 15% and you get 100% of the upper end of the return distribution. Now subtract 7.5% from the mean and you get 0%. About 5% of the distribution is below zero. The entire distribution has a bit of a negative skew relative to the mean.

S&P 500 returns have historically been volatile



That kind of volatility in theory might not seem like much, but as we have all recently experienced, holding stocks for 20 years can be gut wrenching.

What if you were offered an investment with some volatility during your holding period but a near certainty that by the end of your holding period it would return at least the median equity return of 7.5%? It would return no more than that, but you could sleep at night knowing that regardless of market gyrations you would hit the mean.

Courtesy of the upside-down municipal bond market, such an opportunity exists, at least right now, in carefully selected municipal bonds. First, a word of warning: High yields in this market are high for a reason. Be careful. Also, if you plan to buy individual bonds, go to the Internet and look at recent transactions reported on the TRACE system. Brokers in the secondary market are notorious for big-bond markups. Otherwise, buy new issues.

We try to focus mainly on state General Obligation bonds and essential services like power, water, sewer and so on. The recent yields on a couple of bonds we bought for clients (see table below) got us thinking that for true long-term equity accounts, why gamble? Let's take the mean, move on and get some sleep at night.

Example Municipal Bond Yields					
			Yield <sup>1</sup>		
Issuer:	Maturity	Rating	After Tax	Pre Tax - Fed	Pre Tax - NY/CA
New York State Water Authority	June 15, 2035	AA+	5.06%	7.54%	8.02%
San Diego Water Authority	August 1, 2024	AA-	5.05%	7.41%	8.14%

Note (1) Pre-Tax Yields are shown grossed up for federal taxes (Fed) and NY and CA state taxes to show comparable returns.

In practice, investing is not an all or nothing proposition, so we allocated incremental investment dollars to the long-term municipal bond market.

### Interest-rate risk

Bonds do carry interest-rate risk, but in this case the risk is relatively mild. First of all, taxes are rising right now, making our bonds potentially more valuable. Secondly, municipal bond yields are above Treasuries (which does not happen often), so even if long-term Treasury yields rise, it does not necessarily mean that long-term municipal rates will rise. Indeed, the two rates may go back to their historical relationship of municipals trading at a discount thereby bolstering the market value of our bonds.

### My point

If you really do have a 20-year equity holding period, consider taking a disproportionate part of your incremental cash that would normally be invested in equities and invest it in municipal bonds. You will probably sleep better over the next 20 years.

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