

Investment Management **Muni Bonds**

WHAT YOU DON'T KNOW CAN COST YOU

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The world of municipal bonds may seem straight forward and bland to the unsuspecting investor. However, buying and selling municipal bonds can be a very expensive proposition. This newsletter presents some seldom-reported facts about the muni bond market and summarizes suggested prudent practices in constructing a municipal bond portfolio.

Hidden Costs Can Be Significant

Investors in the \$2 trillion municipal market are divided into two, roughly equal-sized groups: (1) the “sophisticated” institutional investor camp which includes insurance companies, commercial banks, trust companies and mutual funds; and (2) the retail investor camp, composed primarily of individuals. According to a recent SEC report, average commissions incurred by the institutional group are 0.10% (or one tenth of 1%) while retail investors paid average commissions of 2.23%.

Why do individual investors pay over twenty two times the commission costs that institutional investors pay?

Understanding the inner workings of the municipal bond market can help a great deal in understanding this stark inequity. The municipal bond market is one of the most opaque areas of the securities market, especially for retail investors. There is significant leeway in negotiating trades for those that have the necessary knowledge to transact effectively. Unlike stock transactions, where prices are posted on a ticker every minute of the trading day and commissions are widely advertised, municipal bonds are traded in a totally different environment. These differences include the following:

- ***The municipal bond market is a “negotiated” market*** – prices are not publicized for the general public to see, but are known only to those who traffic regularly in these bonds.
- ***Commissions are not explicitly disclosed***, but are included in the quoted price of a bond. Therefore, if you don’t know the real price of the bond, you don’t know what you are paying in commissions.
- ***Sellers of municipal bonds trade their own bonds or what they “hold in inventory.”*** The price of a bond (which may be issued by that broker) is controlled by the seller, which often eliminates the opportunity for comparison shopping for the traditional retail investor.

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COMPREHENSIVE WEALTH MANAGEMENT

It is no wonder that we often hear from bond investors that they have never “paid” for municipal bond management. In this business, an investor almost always pays something to someone. The real questions are whether or not the investor knows how much and to whom they are paying.

The SEC’s Report on Municipal Bond Trading

A report published by the Securities and Exchange Commission (SEC) in July 2004 provides compelling evidence as to why individual investors should be wary if they opt to “go it alone” when buying and selling muni bonds in this murky market segment. A summary of this report’s findings follows:

- ***The municipal bond market is 80 times the size of the U.S. stock market.*** There are over 50,000 issuers of municipal bonds and more than 1.1 million varieties of municipal bond securities outstanding.
- ***Municipal bond trading is highly concentrated in a few dealers.*** Of the 1,600 municipal bond dealers, only five of those dealers accounted for more than half of the total market’s trading volume. Thirteen dealers accounted for 75% of all trading volume.
- ***Smaller trades resulted in higher costs.*** The estimated median spread (i.e., “commission”) on a trade in fixed coupon municipal securities was 1.66% of the principal amount traded. Smaller trades cost more – generally hurting the retail investor.
- ***Prices are negotiable!*** The report showed how different investors purchasing (or selling) the same amount of the same bond on the same day frequently paid (or were paid) substantially different prices.

How Safe Are Municipal Bonds?

Municipal bonds are generally regarded as a low risk investment. This assumption is supported by recent studies reporting cumulative default rates for the entire market that are less than 1.5% over the last 20 years. More specifically, AA-rated and AAA-rated bonds had cumulative default rates of 0.13% and 0.0%, respectively.

Digging a bit deeper, the default risk depends greatly on the type of municipal bond and its market sector. Traditional municipal sectors backed by revenues, general obligation (G.O.’s), tax-backed, water/sewer, transportation and public education, are among the least risky classes of debt. Other sectors (e.g., health care, electric utilities and multifamily housing) had default rates in the 1% to 4% range. The most risky municipal sector, industrial development bonds (IDB’s), had cumulative default rates up to 15%, which is commensurate with high yield corporate bonds (also known as “junk bonds”). Therefore, it is important to understand the structure and sectors, not just the rating, of the municipal bonds that you buy.

Staying In the Loop

During the first half of 2005, municipal bond issuers in the southeastern U.S. issued approximately \$36 billion of muni securities. Over \$25 billion of debt issued during the period was sold by negotiation (instead of a competitive bidding process). Having a direct relationship with these underwriting firms was vital to having the opportunity to buy 70% of new bonds issued during that period. Absent these relationships, it is unlikely an investor would see these bonds or have the trading knowledge for negotiating purposes.

Our Approach to Municipal Bond Portfolio Structure

At Diversified Trust, we manage customized municipal bond portfolios tailored to meet the unique needs and circumstances of our diverse client base. Municipal bond management represents a significant component of our total client assets. Our investment process begins by assessing a client’s income and liquidity needs, tax status (federal, state, and local), time horizon and risk parameters. We then construct a portfolio that is well-diversified among issuers typically of an individual’s resident state, using out-of-state bonds only when advantageous net yield differentials exist.

Since most clients view this portion of their portfolio as a safety net, their risk tolerance level usually requires a high credit quality portfolio with low risk. Our typical portfolio will have an average rating of AA as we strive to maintain the delicate balance of maximizing income and protecting

principal. Because this strategy is designed to optimize tax-exempt income for our clients, we primarily employ a “buy and hold” approach. However, we continually monitor each account to ensure that we have proper diversification, optimal income and appropriate credit quality.

We typically stagger bond maturities in a somewhat “laddered” portfolio to provide a predictable income stream and to cushion against interest rate volatility. However, a critical part of the process is taking advantage of attractively priced bonds without a robotic adherence to a perfect ladder. The process of building the portfolio can take from three months up to a year depending on opportunities in the market and client parameters.

How does Diversified Trust Add Value to its Muni Bond Clients?

We add value to our clients in a number of ways through our municipal bond management process:

- ***No inventory to sell:*** We have no bond inventory, and we do not underwrite bond issues, unlike the vast majority of banks and brokerage firms. Instead, we buy and sell bonds on behalf of each of our clients through an extensive, unaffiliated broker/dealer network. We are not limited to the constraints of “selling the inventory.”
- ***Compare and negotiate:*** We negotiate all muni bond trades and constantly compare bond offerings to find the most suitable securities at the most competitive prices for our clients.
- ***Institutional efficiencies:*** When possible, we utilize block purchases (meaning we buy in bulk) for multiple clients to help lower overall trading costs, and to enhance our negotiating presence in the brokerage community. On behalf of our clients during the first half of 2005, Diversified Trust negotiated muni bond trades valued at over \$100 million with 21 different brokerage firms.
- ***Commissions versus Management Fees:*** Diversified Trust receives no compensation from any transaction executed on behalf of our clients. We do not own any interest in, nor are we affiliated with, a broker/

dealer. Instead Diversified Trust receives a management fee based on the total municipal bond assets we manage for each client. Thus, our sole incentive is to negotiate the best terms for our clients in order to maximize the after-tax returns within comfortable risk parameters.

The following is a representative case study comprised of actual facts.

After selling a family-owned business, an individual investor sought the assistance of his long time broker of a national firm to invest a considerable sum in municipal bonds. His broker recommended purchasing the long-term maturities of a particular bond issue the brokerage firm had recently underwritten. These bonds from the same issuer represented approximately 50% of the individual’s total portfolio. The majority of the remaining funds for this investor were invested over the next two weeks – also from the broker’s available bond inventory. Of this remainder, a portion was invested in bonds from other states which provided lower after-tax returns versus in-state bonds due to state income taxes charged on out-of-state bonds.

Over the next several months, a decision was made to sell the concentrated large blocks of his municipal bonds to achieve diversification. Before proceeding with the planned sale, the individual contacted Diversified Trust to request that we provide bids on his bonds for comparison with the bids of his broker. Utilizing our extensive network and knowledge of the most competitive brokerage firms in this area, we provided considerably more competitive bids resulting in a difference of \$11,200 per \$1 million above his broker’s bid. The ultimate benefit to this investor was the receipt of over \$100,000 of additional proceeds. In addition, we advised this investor of the punitive impact of short-term capital gains which would result if he sold his appreciated bonds prior to owning them for a year. In this case, he only needed to wait a few more months to receive the benefit of long-term capital gains treatment and thereby reduce his associated taxes by more than 50%. His broker failed to mention this important consideration.

This case study had a happy ending as this individual investor was able to avoid paying the premium price tag for a round trip muni bond transaction with a retail broker.

We are pleased to report that this investor is now a municipal bond client of Diversified Trust.

The primary purpose of our periodic newsletters is to answer broad questions on a given subject and invite you to ask more detailed questions. We hope the above summary has been useful, and we look forward to providing more information to you as the need arises. Please visit our website which provides greater insight to our organization.

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