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Direct Investments in Munis vs. Bond Funds

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Investors seeking tax-free income might consider bond funds, because of a diversity of investments in a managed portfolio. The 2008 financial crisis, however, highlighted some unexpected risks—fund redemptions in a volatile market with declining credit ratings may force losses when bond prices decline.

Prices of bond funds usually decline for two reasons. When interest rates rise, the value and prices of bonds in a fund decline, causing net asset values to shrink. And if the creditworthiness of bonds in the fund declines, the value and price of your shares will also decline. But fund prices also decline if a fund is forced to liquidate holdings when prices are depressed because fund investors are redeeming their shares.

Long term direct bond investors that do not plan to sell their bonds before maturity are not overly concerned about current prices of their bonds. They receive their interest, and at maturity will receive their principal back. Laddering your bond portfolio can help avoid selling off bonds at a loss in a depressed market by providing maturity paybacks in line your long term spending plans. Laddering moderates interest rate risk by reinvesting maturing principal. Stoever recommends that investors with less than $100,000 are probably better suited to invest in a fund, rather than invest directly.

Bond funds have been hurt by distressed investments like Puerto Rico, which have forced liquidation of bonds in their portfolio, causing losses out of your control. However, your direct bond investment pays on the face value of the bond, and your income (which was your primary reason for purchase) has and will remain the same without annual maintenance fees, as long as you hold the bond to maturity.

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About the Author

RICHARD P. LARKIN, Stoever Glass & Co., Inc.

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee. He ultimately left to take leading roles in municipal hi-yield analysis at firms JB Hanauer & HJ Sims.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.