

Investing In Municipal Bonds, A Search for Diversity

By GERALDINE FABRIKANT

JUST when investors thought municipal bonds were a haven in a chaotic stock market, **Pacific Gas and Electric** filed for bankruptcy -- a sign of the escalating energy crisis in California.

Investors worried that the state's credit could be impaired by huge energy-related costs at a time when its bonds might also be vulnerable to a general economic downturn.

But while these fears helped depress the prices of California municipal bonds, several experts said last week that the overall market was still quite healthy. "Right now is a good time to buy municipal bonds because of the declining interest rate environment," said Robert E. Veasey Jr., president of the Rhode Island chapter of the Financial Planning Association. "Considering income and total return, it is not too late."

But Mr. Veasey is a stickler for diversification -- and for paying careful attention to the health of the underlying borrower.

For example, he said, he would not buy Providence, R.I., issues unless insured because a dwindling tax base over two decades had resulted in its securities being downgraded. He advised investing through bond funds -- and only high-quality ones.

Investors must also consider the tradeoff between the length of time to maturity and the yield. Long-term bonds typically pay more than short-term ones, because there is more time for untoward events, like default or inflation, to occur.

Long-term bond funds, according to the Lipper Group, returned 10.41 percent in the 12 months ended March 31 as investors were rewarded for longer commitments. The average for intermediate funds was 9.03 percent. "We are recommending intermediate-term municipals," said Scott Kahan, president of the Financial Asset Management Corporation, a financial planning group. "The yields may be lower than the long-term bonds, but you will have less volatility. We figure that for every 1 percent change in interest rates, a long-term bond fluctuates 10 percent in the opposite direction."

Worriers can ease their fears by buying insured bonds, to guarantee the timely payment of principal and interest, noted Christopher Ryon, head of the municipal bond unit at the Vanguard Group.

About half of municipal issues carry insurance. "This is definitely something for the timid of heart," Mr. Veasey said. Among his current picks is the Smith

Barney Insured Municipal Bond fund.

Some investment advisers also say it helps to diversify by buying bonds in different states, although a bigger tax advantage typically goes to people who buy bonds issued by their own state or city.

But taxes are only one factor in the decision. Investors who live in low-tax areas may be better off spreading their risk. "A lot of people buy bonds in the state they are *in*," said Deena Katz, a partner at Evensky, Brown & Katz, a financial planning company in Coral Gables, Fla. "The problem is that you are concentrating in one area. If you are not regionally diversified, there is more risk."

For investors who are putting less than, say, \$50,000 into municipals, Ms. Katz says a bond fund, which gives investors better diversification at a reasonable cost, is the best idea. Others set the threshold higher for individual bonds, at perhaps \$100,000.

But funds are no guarantee against losing money -- in 1994 and 1999, for example, interest rates rose sharply, driving down bond prices; Mr. Veasey noted that the Oppenheimer California Municipal bond fund lost 8.54 percent of its value in 1994, partly reflecting a declaration of bankruptcy by Orange County, which lost \$1.7 billion on wrong bets on the direction of interest rates.

INDIVIDUAL bonds allow investors to retain control over decision-making instead of delegating it to a portfolio manager. Investors who suddenly need cash, for example, can choose which bond to sell for maximum tax advantage -- probably the one with the highest cost. Or, if they could use a loss to offset gains from the sale of stocks, they might sell one that had lost value.

One of the most popular ways to evaluate bonds is to compare their returns with those of Treasury securities. Sheila Arnorosa, co-director of the municipal bond department at Franklin Templeton Investments, which runs \$47 billion in municipal bond funds, said that "if municipal bonds are yielding more than Treasuries on an after-tax basis, it is a good time to buy them."

An investor can now buy five-year municipal bonds that are yielding 3.85 percent, compared with five-year Treasuries yielding 4.77 percent. For an investor in the 28 percent tax bracket, that means an after-tax yield of 3.43 percent, making the tax-free munis more attractive.

Mr. Ryon said a reason for bonds' appeal is abnormally high yields, reflecting how much municipals lost favor during the bull market in stocks. And huge supplies have kept returns up, even as the fixed-income group has regained favor.