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So You Want To Build a School

Among the attractive features of tax-exempt municipal bonds is the opportunity for an investor to contribute to community development. To acquire a tax-exempt bond is to help to build a school or new electric, water, or waste-treatment facilities, to improve roads, or to construct recycling facilities, university buildings, civic and governmental centers, and numerous other public projects.

What do you get in return for investing in public projects?

The primary benefit is the obvious benefit: You do not pay federal income taxes on interest received and, in most cases, you also do not pay state taxes. For many, the comfort of not paying taxes on the income is sufficient. Other investors want specific understanding of the value of the tax exemption. For those, here is the formula. Divide the tax-exempt yield by one minus your marginal tax bracket.

The marginal tax bracket is the percentage you pay on the last dollar of your taxable income. Your first dollar of taxable income is not taxed at all. Then, your taxable income falls into brackets, each taxed at a different rate. For example, for a single person, every taxable dollar between \$67,700 and \$141,250 is taxed at 30 percent. If your taxable income does not exceed the highest figure in the bracket, then your highest marginal rate is 30 percent. Don't forget to add state taxes, assuming that the bonds you acquire are exempt from taxes in your state.

If your state has a flat 4 percent rate, then the marginal rate for the formula is 34 percent. One minus .34 equals .66. If you own a tax-exempt bond that pays 3 percent, divide 3 percent by .66, giving a result of 4.54 percent, the "taxable equivalent yield" of your bond. The taxable equivalent yield is a comparison. It says that you must acquire a taxable security that yields 4.54 percent to equal the tax-exempt yield of 3 percent.

Tax-exempt bonds provide comfort, stability, spendable income, and diversification.

Above, we mentioned the most important feature of tax-exempt bonds: yield. The other two important features are quality and maturity. Hence, this acronym: YQM (yield, quality, maturity).

The quality of a bond, taxable or tax-free, is the theoretical probability that the issuer will pay all obligations—that you will get all your interest and principal at maturity. Several investors' services (rating agencies - Moody's, Standard & Poor's, Fitch) rate the quality of bonds using symbols. AAA is the highest rating, the most likely to pay all obligations on time as stated in the bond indenture. Other designations used to give relative indications of credit quality range from Aa to A, Baa, Ba, and to B and into the Cs. Ratings can change while you own a bond. In this fair world of ours, nothing is perfect, and you cannot escape risk,

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unless you want to acquire an “almost perfect bond.” An almost perfect bond is one issued years ago for which the issuer already has deposited money to pay all the obligations. Usually, this money is invested in United States Treasury securities. The bonds are usually rated AAA (unless the issuer did not want to pay a fee for a new rating), and they are widely known as “prerefunded” or “escrowed.” Why, you ask, do we say that such bonds are “almost” perfect? Answer: We don’t know. But we do know that nothing is perfect. There you are.

The “M” in YQM is for maturity. Every bond has a maturity date, that wonderful final moment when all your principal is paid back, plus interest. On that date the bond no longer exists. You must reinvest the funds in a new bond. Otherwise, the money will remain on deposit with the issuer, paying nothing, or it will be sent electronically to your custodian, hopefully to be automatically placed in an interest-bearing asset, such as a money fund. You would be surprised at how much money sits earning no interest. The reason is that investors tend to forget that a bond will mature, or has matured. The Brokaws, Jennings and Rathers of the world do not broadcast maturities. Ideally, every

investor would plan for maturities and make the reinvestment commitment before the maturity date, thereby keeping funds fully invested all the time. Another problem is that attitudes toward investing change. We have different outlooks today than we had on the purchase date of the maturing bond five, ten, or even fifteen years ago. What maturity do we buy today? What quality? And so on. Many investors stew over the decision, further delaying receipt of high income.

The YQM acronym might also be expressed: $Y = Q$ in proportion to M . If this confuses you, it also confuses us, because we just made it up. This expression is supposed to say that in normal markets, your yield goes up as quality goes down and maturity gets longer.

What should you buy in tax-exempt bonds? Our feeling is that you should acquire bonds with a minimum rating of Baa. Conservative investors range from Aaa though Baa—all above investment-grade securities. Bonds with ratings in the Cs or lower are often referred to as high-yield or even junk bonds. If you sleep better with AAA rated bonds or with “almost perfect” bonds, then stick with them. Sleeping better often is more important than eating better; if you don’t sleep well, you might not eat well anyway.

Back to yield, the best for last. To make your life difficult, bonds have several possible yields: current yield, yield to maturity, and yield to call. Every once in a while investors make incorrect decisions (such as leaving one advisor for another) because they do not understand the differences in quoted yields.

Here is our best explanation of yields:

The “current yield” is the interest divided by your price. If you pay \$10,000 for \$10,000 principal amount of bonds, and the bonds pay \$500 per year, your current yield is 5 percent. Importantly, your yield to maturity and your yield to the lowest call price also is 5 percent. What stirs up the jelly is that the purchase prices of many bonds are not equal to their principal. Often investors pay \$9,800 (a discount) or \$10,500 (a premium) for bonds that pay \$10,000 of principal at maturity. The discount bond gives a \$200 bonus at maturity, increasing the yield. For a bond bought at the premium, the investor loses \$500 at maturity. Yuk. Well, maybe not yuk. The premium bond probably compensated the investor by giving a higher “yield to maturity” than the bond purchased at par. “Yield to maturity” is the important statistic. Yield to maturity is what you get. It is the feature that accurately allows comparison of one bond to another. If you compare current yield and yield to maturity of two bonds, your impression will not be accurate. If an advisor says, “I can get you 4 percent,” be sure he/she is talking yield to maturity.

One last bugaboo: Yield to call. Issuers always maintain a right to redeem their bonds early, on the call date, by paying a premium. If you pay \$10,000 for bonds callable at \$10,500, no problem. If you pay \$10,500 for a bond callable at \$10,300 on a date earlier than maturity, your yield will be less than both the yield to maturity and the current yield. So, always know the call feature.

What good are professional investment advisors in all of this? This is what we do well:

First, we invest and reinvest for you, under a written investment policy

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The Talent Myth

On one hand, our society broadcasts that “all persons are created equal.” On the other hand, we expansively reward a few on the theory that they are better than the rest of us. Two examples are sports stars and corporate executives. The market for sports stars is free and competitive. The market for executives is anything but.

Sure, some sports stars are paid too much, but compensation does arise from competition. In football, basketball, and baseball, players may go to the team willing to pay the most, almost like an auction. With dozens of teams competing for quality players, we can assume that personal compensation is a result of supply and demand, the limited supply of people who can hit home runs (I can’t do it), and the huge demand from crowds to see the ball fly over the fence or The Jordan to fly through the air (I can’t do that either). Personal rewards in other professions also depend on how efficiently an individual accommodates demand for service. Salesmen, for example, are routinely paid according to how much they sell. The income of many physicians depends on the number of patients served (and we like to think that physicians who serve a large number of patients are the best because they have earned the loyalty of patients and of other physicians who refer patients). The income of attorneys and accountants is the result of hours billed, and most small merchants are rewarded by the magnitude of activity in their stores. In the executive suite, however, compensation is not a result of measurable criteria, such as hours billed or sales. Nevertheless, corporations argue that they must pay high compensation to attract and to keep the best executive talent. According to a recent study, the “talent mind set” has dominated management theory. The theory is that if you hire and

promote the best, you will outperform your competitors. One of the prominent advocates of this theory is McKinsey & Company, and one of McKinsey’s largest clients was Enron.¹

The McKinsey approach is first to hire the best. At the point of original employment, this is not hard: just hire the magna and summa cum laudes. The problem is what do you do next? McKinsey suggests a semiannual review called “rank and yank” in which employees are sorted into A, B, and C categories. The As are challenged and rewarded. The Bs are encouraged. The Cs are told to shape up or get out. However, McKinsey does not state how to make the rankings or who decides. In the normal course of group dynamics, some of the persons making decisions are Cs themselves, but they escape evaluation because of their status within the company. Also, how do you evaluate two managers, one running an inherently successful product like Windows or Crest, and another running a new product or service that has no history of success and is not as inherently saleable? No criteria exist. The decision is subjective. The decision is political. The decision is based on the most basic human feelings. “Do we like her? OK. She is an A.”

At most companies, employee reviews are made by committees. (Enron utilized committees.) Committees are distinctly unqualified to measure talent. Committee decisions about personnel are dominated by the ever-present black ball. If one member of the committee does not like a

decision, if one member opposes a selection or a ranking of an individual, usually that person is out without a chance. Therefore, to win at the corporate promotion game, an individual must please everyone on the committee, a social/political challenge of the highest order and mostly unrelated to management skill and creativity. (A similar phenomenon controls committees that hire investment managers and consultants for large institutional investment accounts. When the committee reviews 10 or 20 proposals, the unstated goal is to eliminate competitors, to reduce the list to a manageable number. Therefore, if one member of the committee is opposed to a competitor, he/she is out.)

The talent myth reaches its most absurd at the top, where talent measurement is next to impossible, at least with respect to establishing compensation. To argue that the CEO of one company is worth \$100 million, that he or she will leave if not paid \$100 million, that the company will fail if the CEO leaves, that the CEO’s inherent worth to the company is several hundred times greater than the worth of an average employee, or 100 times greater than that of other executives, strains the imagination.² The best companies generally have low-key CEOs and executives. Their lifestyles are protected by high-but-not-exorbitant compensation. The best usually are not flashy. Instead, they are conservative, methodical people, who extend warmth and gratitude to colleagues. While proud, these leaders understand that everyone is replaceable. The very best designate

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¹ Information about McKinsey and Enron is from “The Tipping Point,” by Malcolm Gladwell, originally published in *The New Yorker*, and reprinted in The Babson Staff Letter, October 11 and 25, 2002.

² At Indianapolis-based Consec, directors paid an enormous amount to woo an executive from General Electric, believing that success at GE proved the talent necessary to save Consec. He did not do the job, and was replaced two years later.

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agreement, relieving you of the time and consternation involved in making these decisions. Second, we understand the relationship of yield, quality, and maturity. We understand the yield formulas. We know how to maximize your true and total yield within the context of your stated goals.

That's all, folks.

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their successors, or at least place several persons in a position to lead when the time comes. In so doing, leaders reduce future internal political struggles.

In our view, corporate culture is more important than the talent of individuals. A company with free-flowing communication that allows criticism of old ideas and gives a warm reception to new ideas is likely to be well managed. Most companies should move slowly, deliberately³ to avoid catastrophe and to utilize the valuable experiences of current employees. One executive at Enron said that he was recruiting and promoting persons who think "outside the box." Enron hired lots of top MBA students, each given the incentive to perform quickly or to be ranked C. Imagine the pressure. "It never occurred to them that, if everyone had to think outside the box, maybe it was the box that needed fixing."

³ Exceptions: In most high-tech industries, companies must move very fast because the useful life of inventions is short, and someone else might get to the market first with a new idea.

I Wish My Bond Were Perfect; I Wish That Nothing Would Change

Did we just say, "That's all, folks?" Sorry. There is more. What factors affect the markets for tax-exempt bonds? Lots, and they always change.

The powerful element affecting the tax-exempt market is the individual income tax rate. When tax rates decline, the value of the tax exemption declines. For that reason, you must keep an eye on the president's proposal to accelerate already-legislated reductions in federal income tax rates from 2004 and 2006 to 2003. Our guess is that the reductions, if passed, are not large enough to change your investment policy, but you never know.

The proposal to relieve double taxation of dividends also might affect the tax-exempt bond market. An effect would be to force tax-exempt bonds to compete with tax-

exempt dividends. The jury has not started to deliberate on this one because we do not know whether the proposal will pass, or in what form. Also, we do not know how investors will compare the theoretically low risk of tax-exempt bonds to the theoretically higher risk of stocks paying dividends. Stay tuned.

Lastly, does the quality of bonds change? You bet, and right now many state governments and government-related entities are operating at deficits, thereby increasing the theoretical risk of their bonds. While we are aware of this circumstance, and we cannot rule out payment difficulties, we nevertheless believe that state and local governments will make the necessary decisions to preserve confidence in the bond market. Unfortunately, you know what many of those decisions must be. Yep, higher state and local taxes. When that happens, try to be philosophical. After all, we need the schools, roads, and utilities.

Take Losses Now

The current market has produced many unrealized losses, some in odd situations. One account we know paid extremely low prices for several telephone utilities. These stocks hit highs two years ago, about the time of the client's death. The beneficiaries, there-

fore, own stocks acquired at low prices, but which have a high tax basis, the value on the date of death. In this and many other circumstances, realizing all or some of the loss now makes sense. Having a significant available loss carry forward will be valuable during the next bull market.

Good night, Dorothy. You done good.

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