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Securities offered through Securities Equity Group Member FINRA, SIPC, MSRB

## Tax-Exempt Bond Fund (Municipal Bonds)

### What is it?

A tax-exempt bond fund is a bond mutual fund that invests in tax-exempt municipal debt instruments issued by state governments or agencies, counties, cities, towns, or other political districts. From the shareholder's point of view, the key feature associated with these funds is the advantageous income tax treatment they receive. This income tax treatment is generally the same as that enjoyed by holders of individual municipal bonds. Specifically, just as interest paid by municipal bonds is generally tax exempt at the federal level, so the income generated by municipal bond funds will also be free from federal income taxation.

Further, as with income produced by municipal bonds, the dividends paid by these funds may be exempt from state and local taxes as well. Here the situation becomes a little trickier, however, because the tax advantage at the state level generally applies only to income generated by bonds issued in the taxpayer's home state or local municipality. For example, if you lived in the state of New York and bought shares of a fund specializing in bonds issued only within that state, your income from the fund would be entirely income tax exempt on your New York state return. If you owned a fund made up of bonds from multiple states, though, the dividends you received would likely avoid state income tax only in proportion to the percentage of total fund income attributable to

securities issued in your home state. Any portion of income earned by securities issued outside your home state might be subject to state taxation.

**Caution:** Keep in mind that while dividends derived from income may be tax exempt, dividends derived from capital gains are not.

**Caution:** If you are subject to the alternative minimum tax (AMT), you must include interest income from certain municipal securities in calculating the tax.

**Technical Note:** A tax-exempt bond fund may invest in bonds issued by multiple states, while a state tax-exempt bond fund invests in bonds issued by a particular state.

### When can it be used?

Tax-exempt bond funds may be suitable for somewhat conservative investors who want to invest in mutual funds without the volatility that may accompany stock funds and certain corporate bond funds. They are appropriate for investors seeking current income and for individuals in high tax brackets who want to minimize their income tax liability. Investors with more modest levels of income may not benefit as much from the tax treatment, however. The income they provide also can be used to help moderate volatility from other investments in a portfolio.

**See disclosures on final page.**

## Strengths

### Income tax benefits

The tax advantages are the greatest strength of tax-exempt municipal bond funds. Not only is the income generated by these funds free from federal taxation, but it may avoid state and local taxation in some cases as well. Investors may even enjoy triple tax-exempt treatment. This might occur, for instance, in the case of a New York City resident who would avoid federal, state, and city taxes on the portion of fund dividends representing income earned by New York City bonds. If you pick the right fund, these tax savings can significantly reduce your total tax bill. In general, the higher your tax bracket, the more attractive the tax benefits become.

### Provides current income

Most bond funds seek to provide current income. However, these funds may provide a more reliable source of current income than most other bond funds. Even if you don't need the extra income, you can still reinvest your dividends, or simply allow the income to help moderate the volatility of your portfolio

## Tradeoffs

### Generally modest returns

The return on a given tax-exempt bond fund depends on several variables that affect municipal bond yields, including local economic factors and quality ratings assigned to specific

securities. Because of their tax advantage, returns are generally expected to be lower than with other investments (though the tax advantage also means that depending on an investor's tax bracket, the net return could actually be higher than that of a taxable bond fund).

### Susceptible to interest rate risk and inflation risk

When interest rates rise, bond prices fall. When interest rates go down, bond prices rise. Shares in a bond fund that you may have bought when interest rates were low lose value as interest rates increase because new bonds with higher interest rates can be bought.

Inflation risk refers to the possibility that the return on your investments won't keep pace with increasing price levels. As prices rise, the value of a dollar falls, resulting in a decreased ability to purchase goods and services. Because short-term securities offer a fixed rate income, they assume this kind of risk. If the fixed rate of interest you receive on fund shares is lower than the inflation rate, your investment dollars may not grow enough over the years to allow you to reach your financial goals. Moreover, your current income may lose purchasing power.

Before investing, carefully consider a fund's investment objectives, risks, fees, and expenses, which can be found in the prospectus available from the fund. Read it carefully before investing, as you would with any mutual fund.

#### Disclosures – Important – Please Review

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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