Fixed Income Insight
January 14, 2003

Municipal Bonds & the Bush Plan to Exempt Dividends and Lower Tax Rates

The President's proposal to make common stock dividends generally tax-free raises questions about the impact of a new class of securities competing with municipal bonds. The first public reactions to the proposal ranged from an extreme position of sell all your municipals to a more subdued stance that the change would have only modest impact. We tend to believe that the consequence of such a change, if it were to occur as it is being proposed, would fall closer to the latter position. We believe that the change would draw some attention away from municipals for income-oriented investors but would not be significant or overwhelming in its response. Here's our reasoning:

- The average S&P common share dividend yield on the day of the announcement, January 7, 2003, was 1.71%. While the dividend range is extremely wide, with some troubled companies showing yields in double digit figures, the vast majority of corporate annual dividend levels are currently comparable only with the yields available on high grade AAA munis with maturities in the one to three year range. It does not appear at this time that preferred dividends will be considered for the dividend tax exclusion.

- If the President's plan does what it is expected, dividend-paying stocks would be driven up in price, thereby suppressing stock yields and keeping them relatively low in relation to most municipals, especially those with over five year maturities. Bridgewater Associates, an independent economic insights organization, predicts that price appreciation on stocks would generally amount to 4% - 7% depending on whether a 100% or partial tax exemption on dividends is employed.

- While dividend-paying stocks may maintain a higher potential upside for total return if the stock price moves up due to the tax-free nature of the dividend, it is also possible that stock prices will fall if earnings are weak. Investors are familiar these days with the volatility of stock instruments. We believe municipal investors, by and large, are looking at capital preservation as an important component of their investment decision and will consider favorably the long-standing track record of high grade municipal bonds as an important strength. While credit issues are intensifying on the municipal front, a volatility comparison between stock and bond prices and credit qualities would still favor municipals as the more conservative asset class.

- Municipals are generally trading at higher yield levels relative to the Treasury bond benchmark. According to our statistical tracking of the muni to Treasury yield ratios, municipal bond yields on bonds maturing within two to three years have recently been trading at levels equivalent to over 80% of the yields obtained on similar trading Treasuries. The ten year average ratio relationship falls in the low-to-mid 70% range, which is significantly below recent trade levels. The current higher municipal-to-Treasury relationship substantially absorbs the impact of a dividend tax cut as well as three percent accelerated reduction in federal tax rates as proposed in the Bush stimulus plan. It is quite possible that short maturity munis due in less than five years might be more apt to readjust to a higher historical average ratio of munis to Treasuries, perhaps comparable to their current standing, to account for the more direct yield competition with dividends.

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► There are some additional implications of the dividend cut on municipals that have more to do with the loss of the dividend component of the income tax on state and local revenues. All but a small minority of states derive a major portion of their revenues from the adjusted income calculations tied to the federal income tax. In our view, if dividends are excluded in part or in total, states and many local governments, which either have an income tax or share income tax with the state government, are likely to see reduced revenue numbers. Likewise, we believe the proposed accelerated reductions in the federal tax rates would also have an adverse impact on state income tax collections tied to the federal adjusted income calculation. In any case, federal tax reductions will likely draw down state and local tax revenues at a time when they are scrambling to find new revenue sources to cover projected budget shortfalls. Investors would be required to size up the impact of the reductions on municipal credit quality on an individual basis; however, we believe the vast majority of municipals would remain high grade credit securities either on their own or through bond insurance.

► Our opinion is that any increase in municipal borrowing costs that might occur as the result of the dividend exclusion or the reduction in tax bracket rates are likely to be modest for the reasons mentioned above. The impact might be slightly more significant on short maturities of new bond issues, most likely dealing with serial bonds found on smaller governmental issues, where interest rates would be more comparable to the dividend yields.

In Summary

While we believe there is a realistic probability of some tax reform in the current Congress, the exact outcome of the changes that will occur is far from certain. In our view, a complete or partial elimination of the dividend tax is not likely to cause major havoc in the municipal market. Most or all of this potential risk is already factored into the current pricing relationship relative to taxable securities. We would look for market forces to make modest adjustments to any variation in supply or demand forces that would be impacted by a tax change. The municipal market has periodically made these adjustments after past tax reforms, including the major downward adjustments in tax rates that occurred during the Reagan years. Prudent investors will likely weigh their decisions to buy municipal bonds vs. dividend-paying stocks, in large part, on the basis of a balanced asset allocation philosophy that takes into consideration the intrinsic risk/reward differences between the two asset classes.

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