

**QUARTERLY COMMENTARY**  
**June 30, 2011**

A new tax seldom generates such scant media attention as the one Indiana legislators recently passed on out-of-state municipal bond interest. Nonetheless, Indiana residents and corporations now have yet another new tax burden thanks to their elected officials. The new tax takes effect on January 1, 2012. From that date forward, the interest on otherwise federally tax-exempt bonds issued by states or municipalities outside of Indiana will be subject to Indiana state and county income tax. Municipal bonds purchased prior to this effective date will be “grandfathered,” thereby avoiding the new levy.

While this is a new type of tax for Indiana residents, it is not new to the investment team at Goelzer Investment Management. It turns out that among states that have an income tax, Indiana is the last to apply it to interest from out-of-state municipal bonds. For our many clients who reside outside of Indiana, we have for years managed municipal bond portfolios subject to such taxation.

It is important to note that this kind of tax is essentially voluntary. Investors can avoid it by limiting municipal bond holdings to include only bonds issued within their state of residence. This is an approach often taken by investors and advocated by many advisors. However, Goelzer generally advises against such a strategy given the risk inherent in concentrating bond portfolios in a single state.

Indeed, we are often able to obtain similar-quality out-of-state municipal bonds at yields that are sufficient to cover the added tax cost versus in-state bonds. This allows our clients to effectively remain “tax neutral” in their investments while benefiting from the reduced risk inherent in a well diversified municipal bond portfolio.

As shown in the table below, the amount of additional yield required to offset the cost of Indiana’s state and county taxes is quite small given current interest and tax rates. For example, the additional yield needed on an out-of-state municipal bond maturing in 5 years is just 0.08%. In other words, if we can purchase a similar-quality out-of-state bond at a yield of 1.74% (1.66% plus 0.08%) versus 1.66% for an in-state bond, the added yield will make up for the tax charged against the interest.

<b>Equity Indices</b>	<b>1<sup>st</sup> Qtr.</b>	<b>12 Mo.</b>
<b>S&amp;P 500</b>	.10%	31.11%
<b>S&amp;P 600</b>	-0.17%	36.97%
<b>Russell 1000 Growth</b>	0.76%	35.01%
<b>Russell 1000 Value</b>	-0.51%	28.94%
<b>EAFE (US\$)*</b>	1.80%	31.02%

Total Returns for the period.  
\*an index of foreign stocks.

<b>Interest Rates</b>	<b>3/31/11</b>	<b>6/30/11</b>
<b>90 Day US T-Bill</b>	0.09%	0.03%
<b>10 Yr US T-Bonds</b>	3.47%	3.18%



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## "AA" Rated General Obligation Tax-Exempt Municipal Bonds

Maturity Term (Years)	Yield-to Maturity (Generic Scale as of 6/30/11)	Additional Yield Required*
1	0.44%	0.02%
3	1.07%	0.05%
5	1.66%	0.08%
10	3.10%	0.14%
15	4.09%	0.19%

Source: Bloomberg and Goelzer Investment Management

\*Additional Yield Required to offset the cost of Indiana's 3.4% state income tax plus the 1% median Indiana county income tax.

At a time when many states and municipalities are struggling with budget issues, we believe it is important to emphasize quality and diversification when building municipal bond portfolios. Investors should not let state and county income taxes drive portfolio structure, especially when it is possible to offset some or all of the added tax costs of out-of-state investments through careful bond selection. Like other means of diversifying an investment portfolio, doing so geographically when selecting municipal bonds reduces risk, and if done carefully, can be accomplished without sacrificing yield or quality.

### **Disclosure**

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