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THE VIEWPOINT

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GOVERNMENT VS. MUNICIPAL BONDS

Our last newsletter posed the question: *Are the economic and stock market glasses half full or half empty?* Our answer was: *With the economy growing in spite of all the setbacks we have endured and with earnings projected to continue to grow, we would say the glass is more than half full. This would lead you to expect the economy to continue to grow and the stock market to go up along with earnings.*

The first quarter of 2006 worked out as we expected. The economy has continued to grow and all major US stock market indexes have advanced. Small capitalization companies are out performing large companies and value companies are out performing growth. We continue to feel the market will be positive for the entire year of 2006 but there will be a shift with large companies and growth stocks starting to perform better.

We also expect the Federal Reserve to continue to raise short term interest rates. This has made bonds maturing 10 years or sooner more attractive than they have been the past few years. A year ago, two-year government agency bonds were yielding 4.26%. Today they are yielding 5.33% or 20% more than a year ago.

The yields on AAA rated municipal bonds have not increased as much as government agencies. A two year municipal bond yielded 3.07% a year ago. Today they yield 3.49%. This is only an increase of 14%.

With yields on taxable government bonds increasing more than tax free municipal bonds it might be better to purchase government bonds for taxable accounts in today's bond market. To calculate this, there are three items you need to know: your tax bracket, municipal bond yield and the comparable government bond yield.

Your tax bracket is the tax rate you are paying on the last dollar you earn. You can look at your tax return or ask your accountant for your adjusted gross income then look at the graph below.

| Adjusted Gross Income | | 2005 Tax Bracket |
|-----------------------|-----------|------------------|
| \$29,700 - | \$59,975 | 25% |
| \$59,975 - | \$91,400 | 28% |
| \$91,400 - | \$163,225 | 33% |
| \$163,225 - | | 35% |

To compare the after tax return on government bonds with municipal bonds you need to convert the government bond taxable yield to a tax free equivalent. The formula is: government yield multiplied by (100%-tax bracket). It is very unusual for individuals in higher tax brackets not to benefit by purchasing tax free bonds vs. taxable. This is one of those times. The graph at the bottom of the page shows that in this bond market, almost all clients would be better off in taxable bonds.

This does not mean that individuals should sell their municipal bonds and buy government agency bonds. The spread between the bid and ask price for bonds makes the trade too costly. It does mean that you should be buying taxable bonds with new money until the market adjusts. This is exactly what we will be doing in our clients' accounts that have us manage bonds. Once the market adjusts and bonds have a more normal relationship we will move back to municipal bonds.

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| Tax Bracket | 2 Year | | 5 Year | | 7 Year | | 10 Year | |
|-------------|---------------------------|---------------|---------------------------|---------------|---------------------------|---------------|---------------------------|---------------|
| | Government Tax Equivalent | Municipal AAA | Government Tax Equivalent | Municipal AAA | Government Tax Equivalent | Municipal AAA | Government Tax Equivalent | Municipal AAA |
| 25% | 4.00% | 3.49% | 4.35% | 3.69% | 4.50% | 3.83% | 4.52% | 4.03% |
| 28% | 3.84% | 3.49% | 4.18% | 3.69% | 4.32% | 3.83% | 4.33% | 4.03% |
| 33% | 3.57% | 3.49% | 3.89% | 3.69% | 4.02% | 3.83% | 4.03% | 4.03% |
| 35% | 3.46% | 3.49% | 3.77% | 3.69% | 3.90% | 3.83% | 3.91% | 4.03% |

Bond yields are as of 3/31/2006. Government tax equivalent was calculated using agency bonds rated AAA. Yields are subject to change.