Bond Perspectives
From Morgan Stanley

Pre-Refunded Municipal Bonds

Pre-Refunded Municipal Bonds: Quality & Income

Finding a fixed income investment of quality and high current income can be an important step toward achieving your investment goals. Pre-refunded municipal bonds can provide investors with both of these features in addition to providing tax-free interest income.

Pre-refunded municipal bonds are among the highest quality municipal bonds available. The income and principal from pre-refunded municipal bonds is normally secured by an irrevocable trust of U.S. Treasury securities. Thus, the payments from pre-refunded municipal bonds are no longer dependent upon the revenue stream or tax collections of the original issuing municipality. Because of this enhanced security, pre-refunded municipal bonds generally carry a rating of "AAA."

Since the income earned from municipal bonds is federally tax-exempt, and in most cases, state and local tax-exempt as well, an investment in pre-refunded municipal bonds will often result in more net disposable income than a comparable investment in taxable securities.[1]

Understanding Pre-Refunded Municipal Bonds

Pre-refunded municipal bonds are created when municipalities issue new debt to refinance debt issued when interest rates were higher. Once the refinancing is completed the issuer uses the proceeds of the new deal to purchase U.S. Treasury securities and places these securities in an escrow account. These proceeds are then used to pay interest and principal on the original debt until the bond is called. The call date and price is set when the refinancing is completed; usually the call date is within 10 years of the refinancing, while the call price can be set at a premium, e.g. 101.00, or par. The cashflows from the original issue, revenues or taxes, are diverted from the original deal, to the new issue.

Advantages of Pre-Refunded Municipal Bonds

Higher Cashflows - Due to the higher coupons on pre-refunded municipal bonds, they are priced at a premium to their par value. Some investors may be reluctant to purchase premium priced bonds since, at first glance, it doesn't seem to make sense to buy a bond at 105.23, but only get back 100.00 at the refunding date – less than the original investment. However, pre-refunded municipal bonds are often offered with higher yields than par bonds of similar quality and maturity. This, plus the higher coupon inherent in pre-refunded bonds, creates a higher cashflow over the life of the bond.

[1] *Typically, state and local tax-exemption applies if securities are issued within one's state or city of residence. Some bonds may be subject to Alternative Minimum Tax (AMT).*

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Price Stability - Higher coupon bonds, such as pre-refunded municipal bonds, also tend to exhibit less price volatility in a rising interest rate environment than lower coupon bonds.

Par vs. Premium

The table below illustrates a hypothetical comparison between a municipal bond priced at par and a pre-refunded municipal bond priced at a premium. The purchase of $100,000 face value New York State bonds at par (3.30% due 06/01/2011), would earn $3,300 of tax-exempt income per year, or $18,150 over a five and a half year period. The purchase of $100,000 face value pre-refunded New York State bonds (4.375% pre-refunded to the call date of 06/01/2011), would earn $4,375 of tax-exempt income per year, or $24,062.50 over a five and a half year period. And as our pre-refunded bond has a call price of 101.00, the investor will also receive $1,000 of premium from the pre-refunded New York State bond at the call date, as well as the $100,000 principal.

	Pre-refunded	Par Bond
Credit Rating	Aaa/AAA	Aaa/AAA
Bond Issue	New York State	New York State
Coupon	4.375%	3.30%
Pre-refunded (call) date/Maturity date	06/01/2011	06/01/2011
$ @ Call/Maturity	$101.00	$100.00
YTC/YTM*	3.48% (YTC)	3.30% (YTM)
Purchase Price	$105.23	$100.00
Purchase Quantity	100,000	100,000
Cost	($105,230.00)	($100,000.00)
Principal @ Call/Maturity	$101,000.00	$100,000.00
Interest (11 semi-annual payments)	$24,062.50	$18,150.00
Net Cashflow	**$19,832.50**	**$18,150.00**
Additional cashflow on the pre-refunded bond =	$1,682.50	

This example is for hypothetical purposes only and does not represent the performance of any specific investment. Past performance is not a guarantee of future events.

**YTC = Yield to Call, YTM = Yield to Maturity*
Assumes a purchase date 12/01/2005

As illustrated, even after paying a premium of over 5 points, the investor still comes out $1,682.50 ahead with the pre-refunded municipal bond!

Pre-Refunded Municipal Bonds vs. U.S. Treasury Bills and Notes

Pre-refunded municipal bonds are normally rated “AAA” because they are backed by U.S. Treasury securities. As such, many investors assume that their return will be low because of the high credit quality. However, because pre-refunded bonds generate tax-exempt returns, an investor may be able to earn a higher taxable equivalent yield (TEY) than they would on a treasury security.[2]
To further highlight the benefit of investing with pre-refunded municipal bonds, the following table compares yields of U.S. Treasury bonds and pre-refunded municipal bonds. For investors in high-income tax brackets, the added value derived from pre-refunded bonds is evident.

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[2] *Taxable equivalent yield represents what a taxable investment would have to yield in order to match the tax-exempt yield. The taxable equivalent yield is only one of the many factors that should be considered when making an investment decision.*

Treasury vs. Pre-refunded Municipal Bond Yield Comparisons

Maturity Date	Treasury Yield	Pre-refunded Municipal Bond Yield	33% Federal Tax Bracket TEY	35% Federal Tax Bracket TEY	Yield Pick-up (35% TEY minus Treasury Yield)
2007	4.38%	3.29%	4.91%	5.06%	0.68%
2009	4.39%	3.48%	5.19%	5.35%	0.96%
2011	4.39%	3.69%	5.51%	5.68%	1.29%
2013	4.47%	3.87%	5.78%	5.95%	1.48%

Source: Municipal Market Data Yields, www.tm3.com, 11/15/2005 and www.bloomberg.com, treasuries pages, 11/21/2005

The taxable equivalent yields in the table reflect the benefit of an exemption from federal income tax only. If investors purchase pre-refunded municipal bonds issued in their state of residence, taxable equivalent yields may be higher. Investors should be aware that in most cases the premium paid on a municipal bond held to maturity, or a pre-refunded date, may not be taken as a loss. Morgan Stanley does not offer tax advice, therefore, we suggest you talk to your tax advisor.

Additional Considerations

As with any fixed income security, investors must consider the investment risks associated with pre-refunded municipal bonds:

Interest rate risk - the risk that the market value of securities might rise or fall, primarily due to changes in prevailing interest rates. Like all fixed income securities, pre-refunded municipal bonds are susceptible to fluctuations in interest rates; if interest rates rise, bond prices will fall and vice versa. However, due to the higher coupon and short-term maturity, the duration (sensitivity to interest rates) of a pre-refunded bond is lower than for a comparable quality and maturity bond, hence reducing interest rate risk.

Credit risk - the risk that the issuer might be unable to pay interest and/or principal on a timely basis. However, credit risk is minimized as pre-refunded municipal bonds are backed by a portfolio of U.S. Treasury securities. Pre-refunded municipal bonds are second only to U.S Treasuries in terms of neutralizing credit risk.

Reinvestment risk - the risk that proceeds from the current investment, both interest payments and principal, may be reinvested in a lower interest rate environment. For example, after interest payments are made, available investments may offer lower yields than the current investment. Reinvestment risk is greater on short- to intermediate-term instruments and should be considered before investing in pre-refunded municipal bonds.

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Secondary market - while a secondary market exists for pre-refunded municipal bonds, if you sell your pre-refunded municipal bonds prior to maturity, the price you receive may be more or less than the original cost, depending on market conditions at the time.

For the conservative investor, pre-refunded municipal bonds provide high credit quality with the additional benefit of increased yields over similar quality taxable securities.

For more information on pre-refunded municipal bonds, or any other fixed income product or service, please contact your Morgan Stanley Financial Advisor.

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