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Ballot Question 1: Bond Buyers Beware

With worldwide equity markets recoiling, investors increasingly have sought refuge in the historically safer asset class of bonds and other fixed-income investments.

Many investors seeking greater security have invested in municipal bonds, which generally offer relatively strong credit quality, high after-tax yields and freedom from state and federal income taxation.

Municipal bonds, however, are not entirely free from risk. While historic default rates are relatively low, municipal issuers have defaulted on these obligations several times throughout history, making the credit selection and screening processes critical. In turn, the financial strength of a municipal issuer and the state that empowers the municipality is fundamental to bond prices and, in turn, liquidity.

Prospective and current bondholders should consider a specific political initiative that will be considered by Massachusetts voters on Nov. 4. Question 1, "The State Income Tax Repeal," would repeal the state's income tax on wages, dividends, interest and capital gain and be phased in over a two-year period. For the tax year beginning on or after Jan. 1, 2009, the state income tax rate would be reduced to 2.65 percent, with the full repeal of the 5.3 percent tax taking effect in the 2010 tax year.

Importantly, if passed, this ballot question eventually would deprive Massachusetts and its municipalities of approximately \$12.5 billion in tax revenue, or approximately 39 percent of overall state revenue.

Recent polls indicate that 46 percent of those polled

with regard to the current initiative support it without hearing any of its details.

If it were approved, it likely would have an impact on Massachusetts municipal bonds, as investors presumably would have serious questions about issuer creditworthiness given the sudden lack of funding available to municipalities.

It's reasonable to expect that Massachusetts municipal bond prices would fall in the wake of this initiative and that liquidity, too, would be affected, with sellers outnumbering buyers. It is also reasonable to expect that Massachusetts municipalities nevertheless would pay off their debts and that the state and municipalities eventually would replace much of their lost income with new taxes or fees, but the uncertainty that would likely exist for the short-term could be problematic for bondholders who require immediate liquidity.

For this reason, until there is greater clarity regarding the fate of Question 1, individuals who may require liquid assets over the next several months probably should avoid Massachusetts municipal bonds as an investment vehicle for their short-term funds. For investors with a longer-term perspective, Massachusetts municipal bonds generally should remain a viable, tax-efficient investment vehicle. In the unlikely event that Ballot Question 1 is approved, however, bondholders should be prepared to wait out some volatility in prices prior to maturity.

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