[Losing Dollars in Municipal Bond Funds]

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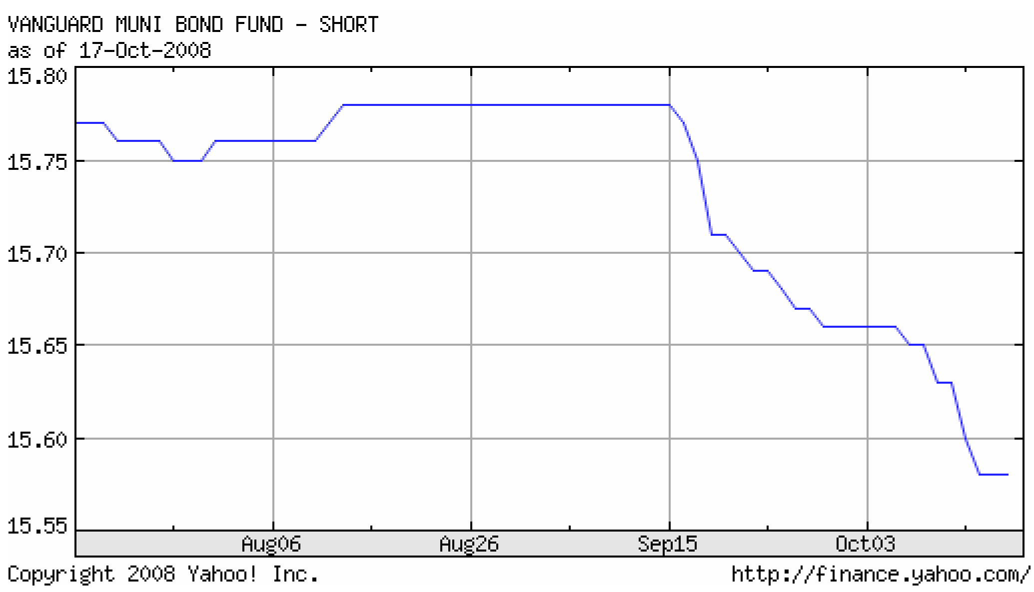
In this fragile time, losing dollars in safe investments is becoming more common place. The Vanguard Short-Term Tax-Ex (VWSTX) is one such fund, and seemingly no one has noticed. VWSTX has a low risk rating from Morningstar. It is composed of high credit quality municipal bonds (AAA and AA) with a relatively short average maturity of 1.2 years. It has been up 30 out of 30 years.

Still, if you bought the fund on September 15, 2008, for just over $15.75 per share and sold it in early October for just below 15.60 per share, you would have lost fifteen cents on every share you purchased. This is not a return of dollar for dollar. Put in its most base terms, money was lost on an investment associated with high safety. What happened, why, and what can we do to prevent this from happening to us?



What happened and why?
Due to our credit crunch, money is tight. Municipalities have to pay more for their new issuance of bonds (think California's recent offerings). Therefore, existing bond values have to decrease so that their yield can go up and compete

with the new issuances. This means the intrinsic value of VWSTX, which is composed of the value of its underlying existing municipals, is a lesser amount than previously. The result: our original fund-investing dollars are worth less. Therefore, investors who are forced to liquidate VWSTX right now will lose money.

What can we do to prevent this happening to us?

According to 2000* research from the Schwab Center for Investment Research, investors who hold at least $50,000 in bonds and don't have to liquidate for 5 years can safely build their own individual bond portfolios using a minimum of ten or more bonds. The big advantage here is that the bond can be held until term so the investor is sure to receive his principal (barring a bond default). The major barrier to doing this to qualified investors is that they feel uncomfortable about choosing their own bonds. Fortunately, this obstacle has diminished recently, because now an investor can build his own bond portfolio according to criteria he specifies on most brokerage websites. For example, I can do this on both E-trade and Ameritrade.

The chart below is helpful in determining which option is best for you. One thing to remember is that municipal bonds do default, and that can affect both a fund and an individual bond portfolio. When choosing bonds yourself, the risk of default can be diminished by buying high quality bonds (AAA and AA) backed by AAA insurance of a municipality with a high credit rating. Insurers that still retain a high rating include Berkshire Hathaway, Financial Security Assurance (FSA), and Assured Guaranty.

	Municipal Bond Fund	**Individual Municipal Bonds**
Investment minimum	Often 3K	50K or more
Liquidate	Anytime	Preferably at term
Diversification	Consistent with mission (short, intermediate or long term bond funds)	OK with 10 bonds and above (Schwab research)
Dividends	Can be automatically invested	Put into money market (likely less interest)
Management	Professional	Self

As Warren Buffet says, "Risk comes from not knowing what you're doing." A better understanding about municipal bonds, if you are a buyer, can only help.

* Joseph Hoffman: Should You Invest in Individual Bonds or Bond Mutual Funds? Financial Planning Perspectives, February, 2000.