TAX-FREE MUNICIPAL BONDS

An Investment for Today's Tax-Conscious Investor

INVESTMENT SERVICES

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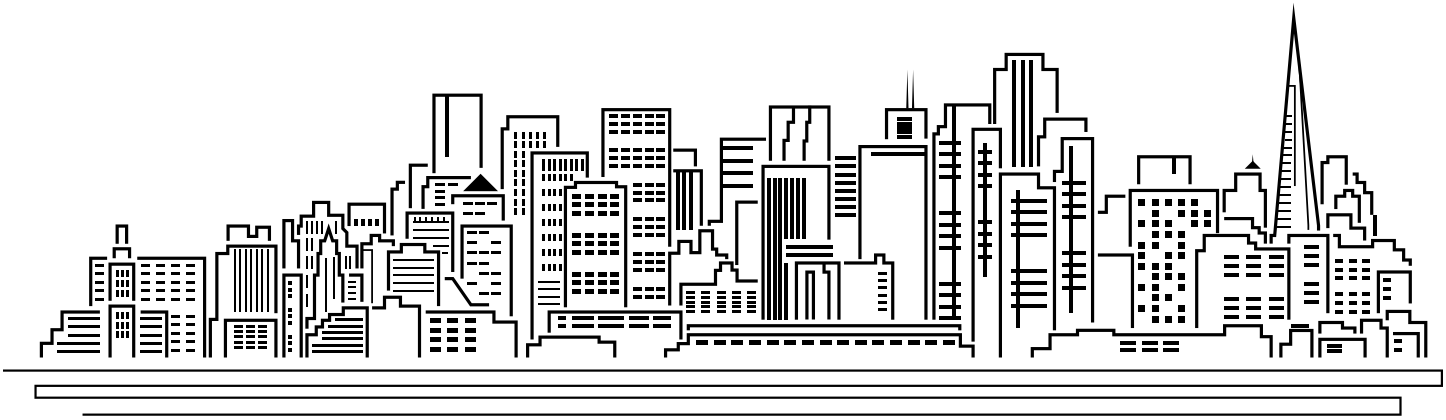

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WHAT ARE MUNICIPAL BONDS?

Municipal bonds are debt obligations issued by states, cities, counties and other governmental entities to raise money to build schools, highways, hospitals and sewer systems, as well as many other projects for the public good.

When you purchase a municipal bond, you are lending money to an issuer who promises to pay you a specified amount of interest (usually paid semi-annually) and return the principal to you on a specific maturity date.

TYPES OF TAX-EXEMPT MUNICIPAL BONDS

Municipal securities consist of both long and short-term issues. Short-term securities, often called notes, typically mature in a year or less, while long-term securities, commonly known as bonds, typically mature in more than a year. Short-term notes are used by an issuer to raise money in anticipation of future revenues such as taxes, state or federal aid payments, bond proceeds, and to cover irregular cahs flows, meet unanticipated deficits and raise immediate capital for projects until long-term financing can be arranged. Bonds are usually sold to finance capital projects over the longer term. The two basic types of municipal securities are:

General obligation bonds: Principal and interest are secured by the full faith and credit of the issuer and usually supported by either the issuer's unlimited or limited taxing power. General obligation bonds are also voter approved.

Revenue bonds: Principal and interest are secured by revenues derived from tolls, charges or rents paid by users of the facility built with the proceeds of the bond issue. Public projects financed by revenue bonds include toll roads, bridges, airports, water and sewage treatment facilities, hospitals, and housing for the poor. Many of these bonds are issued by special authorities created for this purpose.

BENEFITS OF TAX-EXEMPT MUNICIPAL BONDS

Tax-exempt municipal bonds are among the most popular types of investments today, and with good reason. They offer a wide range of benefits, including:

- Attractive current income free from federal, and in some cases, state and local taxes
- High degree of safety with regard to payment of interest and repayment of principal
- Predictable stream of income
- Wide range of choices to fit in with your investment objectives with regard to investment quality, maturity, choice of issuer, type of bond and geographical location
- Marketability in the event you must sell before maturity

THE ADVANTAGES OF TAX EXEMPTION

Under present federal income tax law, the interest income you receive from investing in municipal bonds is free from federal income taxes. In most states, interest income received from sercurities issued by governmental units within the state is also exempt from state and local taxes. In addition, interest income from securities issued by U.S. territories and possessions is exempt from federal, state, and local income taxes in all 50 states.

One of the best ways to appreciate the tax-exempt advantage of a municipal security is to compare it to a comparable taxable investment. For example, assume you are in the 33% federal tax bracket, file a joint return with your spouse, and claim $185,000 in taxable income.

Now assume you have $30,000 to invest and you are considering two investment alternatives: a tax-exempt municipal bond yielding 5.0%, and a taxable corporate bond yielding 7.0%. Which investment will prove most advantageous?

If you invested your money in the municipal bond, you'd earn $1,500 in interest per year (a 5.0% yield) and pay no federal income taxes. The taxable bond investment, however, would provide you only $1,407 [er year in income after federal income taxes had been deducted (a 4.7% yield).

As you can see, the municipal bond would provide the best yield after taxes are taken into account. The tax-exempt security would be an even better investment if you accounted for state and local income taxes when calculating returns on the taxable bond investment.

UNDERSTANDING YIELDS

There are basically two types of bond yields you should know about: current yield and yield to maturity.

Current yield is the annual return on the dollar amount paid for a bond. Yield to maturity is the rate of return you receive by holding a bond until it matures. It equals the interest you receive from the time you purchase the bond until maturity , plus any gain (if you purchased the bond below its par, or face, value) or loss (if you purchased it above par value).

Tax-exempt yields are usually stated in terms of yield to maturity, with yield expressed at an annual rate. If you purchase a bond with a 6% coupon at par, its yield to maturity is 6%, If you pay more than par, the yield to maturity will be lower than the coupon rate. If purchased below par, the bond will have a yield to maturity higher than the coupon rate.

When the price of a tax-exempt security, or any bond, increases above its par value, it is said to be selling at a premium. When the security sells below par value, it is said to be selling at a discount.

HOW SAFE ARE MUNICIPAL BONDS?

When you invest in any bond, your primary conern should be the issuer's ability to meet its financial obligations. Issuers of municipal bonds historically have an outstanding record of meeting interest and principal payments in a timely manner.

Issuers disclose details of their financial condition through "official statements" or "offerings circulars", which are available from your bank, brokerage firm, or on the Internet. Issuers also provide continuing disclosure about their financial condition through nationally recognized municipal securities respositories. You may also contact the issuer or visit the issuer's website for ongoing information (EMMA - Electronic Municipal Market Access).

Another way to evaluate an issuer is to examine its credit rating. Many bonds are graded by rating agencies such as Moody's Investors Service, Standard & Poor's and Fitch Ratings. A number of banks and brokerage firms have their own research departments which also analyze municipal securities. Bond ratings are important benchmarks because they reflect a professional assessment of the issuer's ability to repay the bond's face value at maturity.

Generally, bonds rated BBB or Baa, or better, by Standard & Poor's and Fitch, or Moody's, respectively, are considered "Investment Grade", suitable for preservation of investment capital.

CREDIT RISK	MOODY'S	S&P'S	FITCH
PRIME	Aaa	AAA	AAA
EXCELLENT	Aa	AA	AA
UPPER MEDIUM	A	A	A
LOWER MEDIUM	Baa	BBB	BBB
SPECULATIVE	Ba	BB	BB
VERY SPECULATIVE	B, Caa	B, CCC, C	B, CCC, C
DEFAULT	Ca, C	D	D

Credit ratings should not be the sole basis for an investment decision. For example, the ratings do not take into account market trends.

Tax-exempt municipal bonds offer you the chance to maximize your after-tax return consistent with the amount of risk you're willing to accept. In general, as with any fixed-income investment, the higher the yield, the higher the risk.

RISKS OF OWNING BONDS

Call risk – The risk that a bond may be called by the issuer prior to maturity. This is more likely to happen during periods of declining interest rates.

Credit risk – The risk that a borrower may be unable to make interest or principal payments when they are due.

Default risk – The risk that a borrower may be unable to make interest or principal payments when they are due.

Inflation risk – Inflation leads to higher interest rates, which drives down the prices of bonds. Inflation also reduces the purchasing power of the future interest and principal payments of a bond.

Interest rate risk – When interest rates decline, bond prices rise and when interest rates rise, bond prices fall. Bond with more time until maturity have higher interest rate risk than those with shorter maturities.

Legislative risk – The risk that changes in the tax code can affect the value of tax-exempt or taxable security.

Liquidity risk – The risk that an investor may have a difficult time finding a buyer of a security when trying to sell that security, which may force the investor to sell the bond significantly below market value.

Market risk – The risk that the bond market as a whole will decline. This can decrease the values of individual securities, regardless of other characteristics. When interest rates fall, new issues come to market with lower yields than older securities, making the older securities worth more, which explains the increase in price.When interest rates rise, new issues come to market with higher yields than older securities, making the older ones worth less, which explains the decline in price.

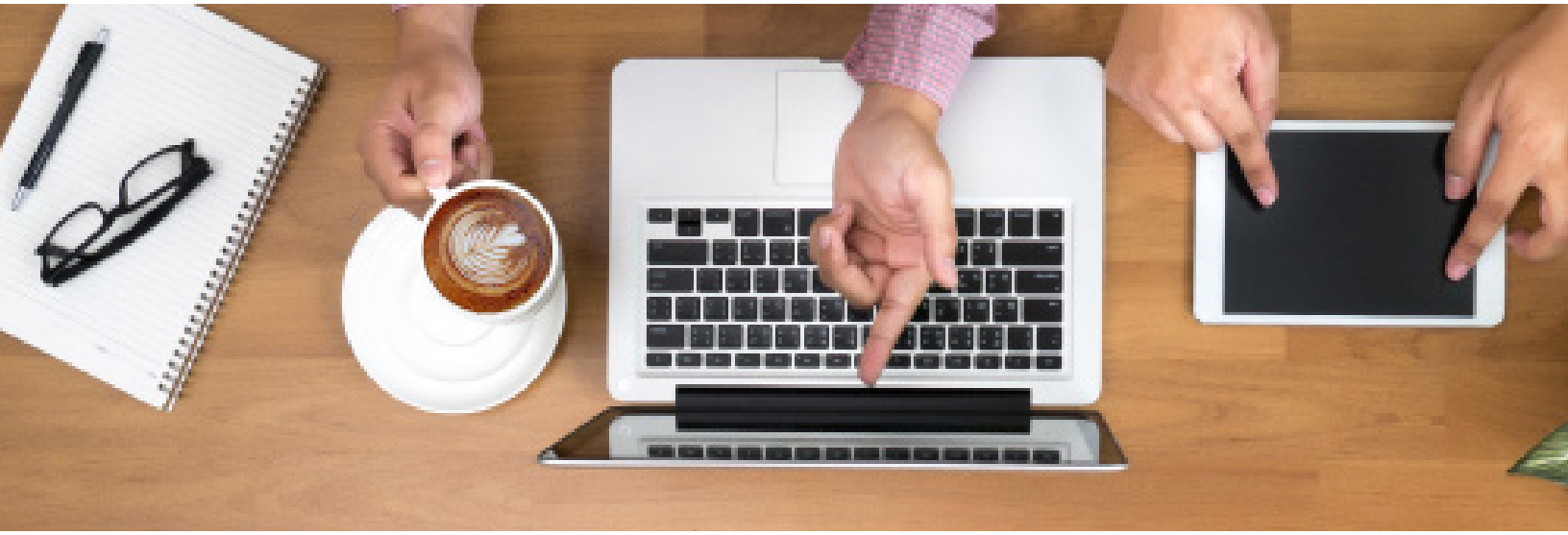
Reinvestment risk – When interest rates fall and investors have to reinvest interest income and the return on principal of their bonds, that money will be reinvested at the lower rates available in the market.

Selection risk – The risk that a specific security performs worse than the market for unanticipated reasons.

Timing risk – The risk that an investment performs poorly when purchased or better after being sold.

UNDERSTANDING CALLS

Many bond issues allow the issuer to call - or retire - all or a portion of the bonds at a premium, or at par, before maturity.When buying bonds, be sure to ask you investment advisor about call provisions. Investment advisors will typically quote the yield to call and yield to maturity when the yield to call is lower. This will generally occur when the bonds are trading at a price above the initial call price.



GAINS AND LOSSES

You may generate capital gains on a tax-exempt security if you sell it at a profit in the secondary market before it matures. Long-term capital gains (which require a 12-month holding period) result from the sale of tax-exempt municipal bonds and are taxed at a maximum rate of 15% for all sales.

Of course, if you sell your security for less than your original purchase price, you may incur a capital loss. Under current law, up to $3,000 of net capital losses can be used annually to reduce ordinary income. Capital losses can be used without limit to reduce capital gains.

Special rules apply to a tax-exempt bond purchased at a premium or a discount and called or sold before maturity. (Since tax laws frequently change, consult with your tax accountant for up-to-date advice).

BONDS WITH SPECIAL INVESTMENT FEATURES

Insured municipal bonds: Many municipal bonds are backed by municipal bond insurance specifically designed to reduce investment risk. In the unlikely event of default, an insurance company which guarantees payment is responsible for both interest and principal payments.

Floating-rate and variable-rate bonds: These securities are attractive in a rising interest rate environment. Generally, interest is periodically recalculated based upon a percentage of prevailing rates for Treasury bills or other interest rates.

Zero-coupon, compound interest and multiplier bonds: These are issued at a deep discount of the maturity value and have no periodic interest payments. You receive one lump payment at maturity equal to principal invested, plus interest compounded semi-annually at the original interest rate. Because they do not pay interest until maturity, their prices tend to be volatile. These bonds are especially attractive if you seek to accumulate capital for a long-term financial goal such as retirement planning or college costs.

Put bonds: Some bonds have a “put” feature which allows you to redeem the bond at par value on a specified date long before its maturity date. If interest rates increase, you can cash in the bonds at any put date, recoup the principal and purchase higher-yielding bonds.

BOND MARKET: WHO BUYS?

The largest owners of tax-exempt securities are individuals like yourself, mutual and money market funds, property and casualty insurance companies, and commercial banks. In recent years, individual participation in tax-exempt municipal bonds has expanded significantly through investments in unit investment trusts and mutual and money market funds.

ABOUT ALAMO CAPITAL

Established in 1987, Alamo Capital is a Broker/Dealer located in Walnut Creek, California. With over 30 years of specializing in tax-exempt investments, our aim is to provide timely and efficient executions of investment transactions for our retail, institutional and wholesale clientele. As a full service investment firm clients have access to fixed-income investments, equities, retirement planning and all aspects of insurance with the help of our account representatives with a “can-do” attitude. Alamo Capital is certified with the NWBOC (National Women Business Owners Corporation), WBENC (Women’s Business Enterprise National Council), the SBE (Small Business Enterprise) and BBB Rated A+.

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