TIAA CREF

Nicholas Janulis

5/30/01

Stuart,

For your records, enclosed is a copy of the June 2001 issue of Investment Forum, in which your municipal bond story appeared.

Nick

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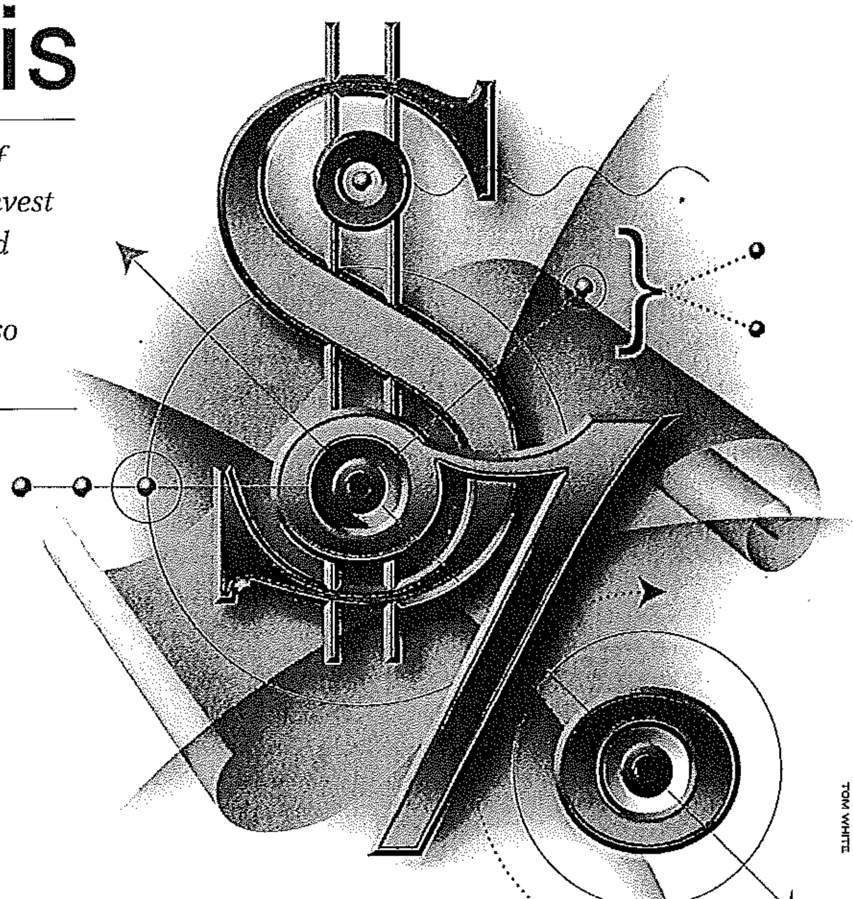
Reduce Your
After-Tax Bite
With Munis

When creating an after-tax portfolio of stocks, bonds, and mutual funds, you invest in bonds to diversify your portfolio and receive income. But if you're in a high income-tax bracket, you're probably also concerned about the impact of taxes.



TOM WHITE

AFTER ALL, BOND INTEREST IS NORMALLY taxed as high as 39.6 percent at the federal level. It's also subject to state and local income taxes, depending on where you live. That means you could lose nearly half of the interest because of taxes—unless, of course, you invest in municipal bonds (munis).*

Municipal bond interest income is tax-free to you, at least at the federal level. If you happen to reside in the state where the muni bond is issued, your income may also be free of state income tax. That makes munis very attractive compared with U.S. Treasury bonds and investment-grade corporates, two types of taxable bonds with which munis are often compared.

State and local governments issue municipal bonds to finance public projects such as roads, schools, and sewer systems. Some are "general obligation" bonds, which are backed by the full faith, credit, and taxing power of the issuer. Others are "revenue" bonds, which finance bridges, tunnels, hospitals, and other public works, and are backed by income from the project.

When you invest in a municipal bond, you're lending money to the municipality, which promises to pay you a certain amount of interest typically every six months, returning your principal on a specified

*This article presents an overview of municipal bonds and municipal bond funds. Before investing in municipal bonds and/or funds, you should gain a thorough understanding of the tax rules and confer with your tax and/or investment advisor.

maturity date. You can hold the bond until maturity or sell it beforehand in the marketplace.

In many cases, the tax-free yield on a municipal bond is higher than you would get on a taxable bond of comparable credit quality—after you pay income taxes. And the higher your tax bracket, the better your return when compared with that from a taxable bond (see "The Muni Tax-Free Advantage" on this page).

On the other hand, if you're in a very low tax bracket, say 15 percent, munis probably aren't for you. For example, a municipal bond that pays 5.5 percent won't be as good as an AAA-rated corporate bond that pays 7 percent interest. To a person who pays 15 percent in federal taxes, the corporate bond would yield 5.95 percent after taxes (7% x 0.15 = 1.05% to the government, leaving 5.95%).

Unlike U.S. Treasury bonds, municipal bonds aren't considered totally risk-free from a credit standpoint, even though they are issued by a local governmental entity. Instead, municipal bonds with strong credit ratings are comparable in risk to blue-chip corporate bonds.

MUNICIPAL BOND OPTIONS

The Muni Tax-Free Advantage

Let's say you're in the 36 percent tax bracket and you have a choice between a 10-year AAA-rated municipal bond paying 5.5 percent interest and a comparable corporate bond that pays 7 percent. Which would you choose?

There are many ways to do the math. One method is to multiply 7 percent by 36 percent, arriving at 2.52 percent, the amount paid in taxes. Then subtract 2.52 percent from 7 percent. (The after-tax amount left over is 4.48 percent.) In this example, you would prefer the municipal bond, because the tax-free rate of 5.5 percent is greater than the after-tax yield of 4.48 percent on the corporate bond.

COMPARING AFTER-TAX YIELDS OF MUNICIPAL AND CORPORATE BONDS

	5.5% Municipal	7% Corporate
Investment	$10,000	$10,000
Interest	$550	$700
36% Tax Bracket	$0	$252
Net Return	$550	$448
After-Tax Return	5.5%	4.48%

This table is for illustrative purposes only. It does not reflect performance of any TIAA-CREF investment. Past performance doesn't guarantee future results.

Invest Through TIAA-CREF Tax-Exempt Bond Fund

TIAA-CREF Mutual Funds Tax-Exempt Bond Fund (TCTEX) primarily invests in investment-grade municipal bonds. The fund can invest up to 20 percent of its assets in private activity bonds or other securities that may be subject to the alternative minimum tax (AMT). It can also invest up to 20 percent of its assets in lower-rated, higher-yielding securities.

Net invested assets as of 3/31/01: $41.6 million. Total return since inception (4/3/00) is 10.52 percent, as of 3/31/01.* Annual expense charge is 0.30 percent. As of 3/31/01, the net annualized 30-day current yield is 4.45 percent. For more complete performance information, see Performance Highlights on page 18.

For more information, including a prospectus, please contact our Planning and Service Center at **800 223-1200**. Read the prospectus carefully before you invest.

* Returns shown reflect a voluntary waiver of part of the investment management fee that will remain in effect until July 1, 2006. If there had been no waiver, total returns would have been lower. Past performance doesn't guarantee comparable returns in the future. Both the returns and the value of your invested principal will fluctuate, and at redemption your shares may be worth either more or less than what you originally paid.

TIAA-CREF Trust Company Offers Customized Portfolios

As a client of the TIAA-CREF Trust Company, FSB, you can have your personal portfolio manager customize a portfolio of municipal bonds. Your manager will discuss how much after-tax money you have to invest and, based on your needs, tax situation, time horizon, and risk profile, will analyze whether you should invest in individual municipal bonds or in the TIAA-CREF Mutual Funds Tax-Exempt Bond Fund. If a client wants state income tax exemption, the Trust Company can also recommend other tax-exempt funds.

If you're investing in individual municipal bonds, your portfolio manager will work with our municipal bond investment management team.

The Trust Company's investment management services are most appropriate for individuals or families who have $500,000 or more in non-TIAA-CREF investment assets. To learn more, you can contact one of our Trust Consultants at **888 842-9001**.

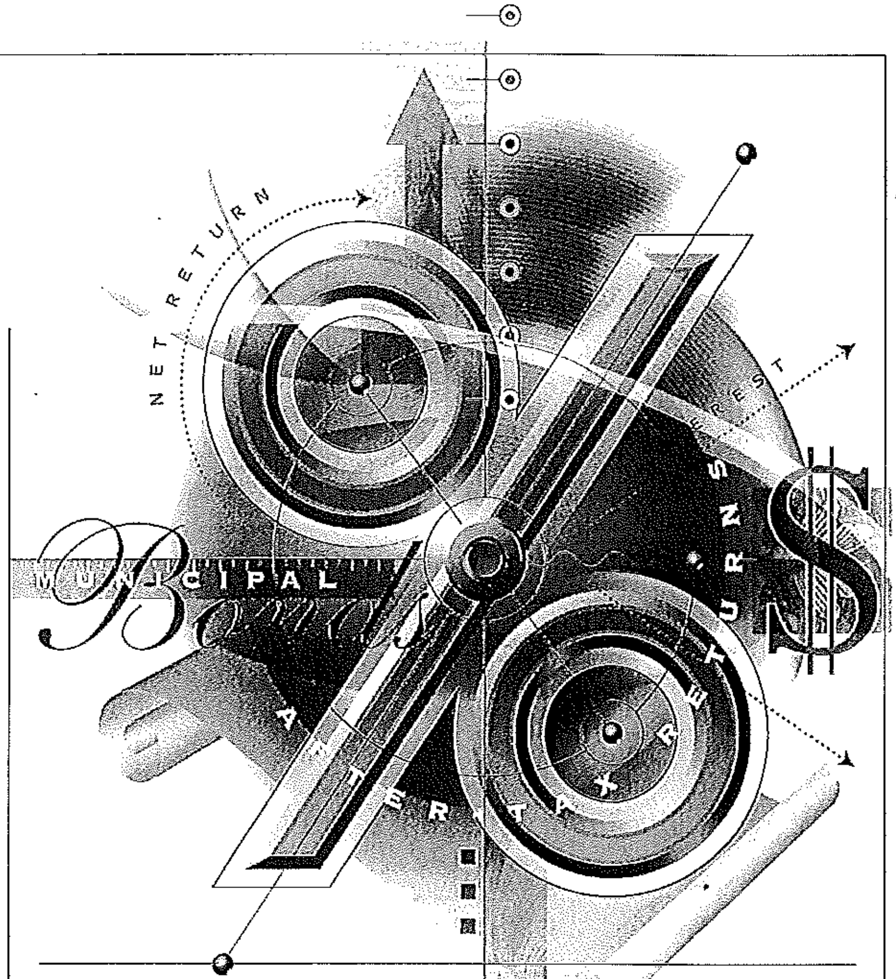
Investment products are not insured by the FDIC; are not deposits or other obligations of TIAA-CREF Trust Company, FSB; are not guaranteed by TIAA-CREF Trust Company, FSB; and are subject to investment risks, including possible loss of principal invested.

Like corporate bonds, municipal bonds have credit ratings published by independent national credit rating agencies, such as Moody's Investors Service, Standard & Poor's (S&P), and Fitch. For example, S&P has the following credit ratings for municipal bonds: AAA (Prime), AA (Excellent), A (Upper Medium), BBB (Lower Medium), BB (Speculative), B, CCC, CC (Very Speculative), and D (Default). In recent years, about half of all newly issued municipal bonds have been insured. In the event of a default, the insurance company pays the bondholder. Typically, an insured bond receives an AAA rating.

Market Risk, Call Risk

As in any fixed-income security, a municipal bond's value will fluctuate daily, depending on market conditions, particularly the current level of interest rates. When interest rates rise, the value of your existing bond declines, because it pays a fixed rate of interest that is lower than what the marketplace is offering. Conversely, the value of your bond appreciates when interest rates decline. Your bond's sensitivity to changes in interest rates will largely depend on the number of years until the bond's maturity —the longer the time frame, the more sensitive it will be. If you're concerned about market risk, consider investing in a bond with a short maturity. Typically, however, you'll also receive a lower yield from a shorter-term bond.

If you're not concerned about market risk because you intend to hold the bond until maturity, consider investing in long-term munis, which may offer a higher yield. Or you might decide that you want to forgo the semiannual income and buy a zero municipal coupon bond. Zero munis don't pay interest, but you can buy them at steep discounts, because the money that you would have received in interest is reinvested for you.



IN MANY CASES, THE TAX-FREE YIELD ON A MUNICIPAL BOND IS HIGHER THAN YOU WOULD GET ON A TAXABLE BOND OF COMPARABLE CREDIT QUALITY—AFTER YOU PAY TAXES.

Beyond credit risk and market risk, there's the risk that the issuer will "call" the bond, or retire it prior to maturity. Some bonds come with a call provision that lets the issuer redeem them within, say, 10 years. This will happen if interest rates fall significantly. An issuer's ability to call a bond is similar to the homeowner's ability to refinance. If you're a homeowner, you're no doubt aware that you can refinance your mortgage to take advantage of lower rates if mortgage rates fall. In the municipal bond arena, callability is something that issuers value a great deal, and they're usually willing to pay higher yields in

Teachers Personal Investors Services, Inc. distributes the TIAA-CREF Mutual Funds.

exchange for this right. Conversely, if you want protection against calls, you'll probably have to accept a lower yield.

Pros and Cons of Muni Funds

Municipal bond mutual funds are a good way to diversify, trying to minimize call and market risks. Certainly, if you have $10,000 to invest, you could buy two municipal bonds (minimum denominations are $5,000). Or you could buy shares in a mutual fund portfolio of perhaps 100 municipal bonds. The latter option minimizes the slight risk that you'll buy a bond that goes sour. In addition, you'll have the advantage of a portfolio management team with years of training in evaluating bonds for credit, market, and call risks.

BEFORE INVESTING IN AN INDIVIDUAL MUNI OR A MUNI BOND FUND, YOU SHOULD CHECK TO SEE WHETHER IT'S SUBJECT TO THE ALTERNATIVE MINIMUM TAX.

The one significant tax drawback of mutual funds is that they typically generate capital gains distributions every year. These distributions represent the profits that the portfolio manager at the mutual fund has realized when selling securities. Investors in muni bond funds are often surprised to discover capital gains distributions on what they thought was a tax-free investment. You can also generate a capital gain or loss on the sale of an individual municipal security. If you hold the security for over one year, you'll pay a 20 percent long-term capital gains tax. If you hold it for less than one year, the federal income tax can be as high as 39.6 percent.

Some municipal bonds may be subject to the alternative minimum tax (AMT), an alternative tax system that does away with most write-offs in exchange for a lower tax rate. Typically, you would calculate your taxes using both the regular income tax system and under the AMT and pay whichever amount is higher.

Before you invest in an individual municipal bond, you should check to see if it is subject to the AMT. With a municipal bond fund, you'll need to see if it invests in "private activity" bonds, which are subject to the AMT. These are municipal bonds that are issued to finance projects that involve private enterprise. An example is the construction of a football stadium that provides dual benefits to a city as well as a group of business people.

If you invest in a mutual fund, the prospectus will indicate whether the fund may purchase AMT securities. In order for a municipal bond fund to be called tax-exempt or tax-free, it can invest only up to 20 percent of its assets in AMT securities. Otherwise, it can only be called a municipal bond fund. At the end of the year, your mutual fund's tax report will let you know what percentage of the fund is subject to the AMT.

Typically, private activity bonds pay higher yields because they are counted as income for AMT purposes. Under certain circumstances, that can create opportunity: If you're not subject to the AMT, you might purposely buy AMT bonds because of the higher yield.

Because of the tax-free status of municipal bonds, you shouldn't put them into a retirement plan, which already shelters investments from taxation. Instead, keep them outside, where you, not Uncle Sam, can enjoy the income.