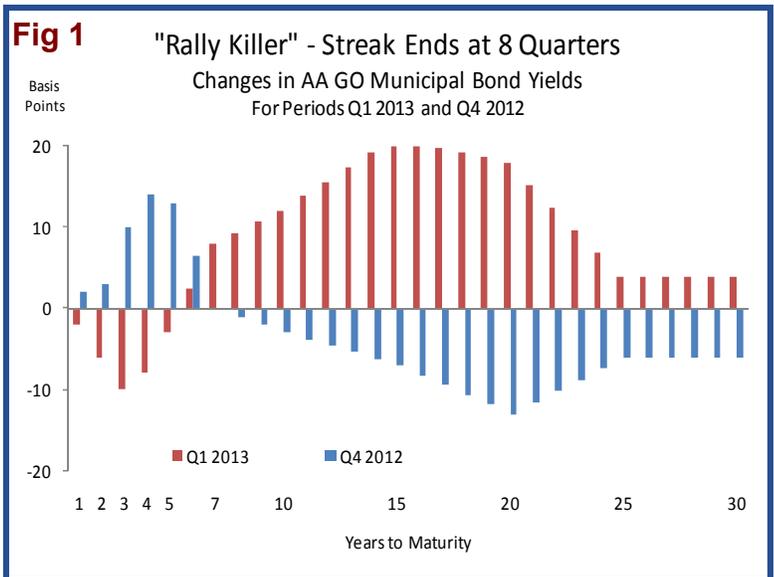




Municipal Market Review

First Quarter 2013

The two-year rally streak in municipal bond yields came to an end in the first quarter of 2013. After falling for eight consecutive quarters, municipal bond yields rose modestly, but unevenly, during the first quarter of 2013. Referring to **Figure 5**, we can see that with the exception of maturities of five-years and less, municipal bond yields rose all across the yield curve. The reshaping of the yield curve is better reflected in **Figure 1** which graphs the changes in municipal yields across the curve for both the first quarter of 2013 and the fourth quarter of 2012. As we can see in **Figure 1**, while yields on bonds maturing under 5-years rallied modestly, yields on maturities over 5-years rose, with the largest increase in yields occurring in the intermediate part of the yield curve. (10-year to 20-year area) Interestingly, comparing the change in municipal yields for the first quarter of 2013 and the fourth quarter of 2012, suggests that the increase in municipal yields which began in December of 2012 due to increased capital gain harvesting driven by the heightened level of uncertainty surrounding the Fiscal Cliff negotiations, continued into the first quarter of 2013. This observation is reinforced by data on cash flows into municipal bond mutual funds. These cash flows turned negative in December of 2012 with outflows of approximately \$3 billion, but then rebounded in January and February of 2013 with inflows of \$7 billion and \$2.5 billion respectively. However cash flows in March had again turned slightly negative, with outflows of approximately \$200 million, suggesting the possible sale of municipal bonds to pay income taxes and/or a softening of demand due to heightened uncertainty, perhaps that associated with the Cyprus banking crisis which unfolded throughout the month of March. As a result of the reshaping of the municipal yield curve, the yield curve underwent a modest bearish steepening of the yield curve. Specifically for the year-to-date period ending March 31, 2013, the 2s-to10s segment of the yield curve steepened by **18 basis points**, while the 10s-to-30s segment flattened by **8 basis points**. Overall, as measured by the 2s-to-30s segment, the municipal yield curve steepened by **10 basis points** to a level of **362 basis points** and as such, remains historically steep compared to the 10-year average of **333 basis points**. The reshaping of the Treasury yield curve effectively mirrored that of the municipal yield curve, with yields declining slightly in shorter maturities while rising modestly in the longer maturities. The effect of the combined reshaping of the municipal and Treasury yield curves on relative value ratios is reflected in **Figure 6**, where we can see that aside from a modest decline in the 1-to-5 year segment of the yield curve, **municipal relative value ratios** were effectively unchanged for the quarter. Despite the modest decline in shorter-maturities, municipal bonds continue to be quite attractive as relative value ratios **remain above 100 percent for all bond maturities**.



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One question that we are often asked, particularly by prospective municipal clients, is; *"For a buy-and-hold portfolio strategy, don't you just want to simply purchase the highest yield available?"* On its' surface, the very nature of the question seems almost rhetorical. After all, if the only consideration is purchasing the highest yield available and placing it in a portfolio, then given the availability of on-line trading tools, shouldn't the attentive investor simply do this for themselves? The answer, in our opinion, is bound up in a quote by former Secretary of Defense Ronald Rumsfeld who once cogently observed; *"There are unknown unknowns. These are the things we don't know we don't know."* And with the municipal bond market, it is indeed the things that **we don't know we don't know** that are the issue.

While yield is important, a myopic focus on yield ignores the fundamental nature of the municipal market - the municipal bond market is **unique**. Aside from their most well known peculiarity, the tax-exempt status of their interest income, municipal bonds are unique among fixed-income asset classes in another important aspect. Unlike other fixed-income markets, **individuals**, not institutions, make up the largest investor base for municipal bonds, owning nearly **75 percent** of all issues. The municipal market is unique for yet another reason -- it is **not a homogenous market**. Instead, the \$3.7 trillion municipal bond market is comprised of over **1 million dissimilar bond issues** of all shapes and sizes, issued by nearly **50,000 separate state and local entities**, each carrying its own unique credit risk profile. As such, no two credit profiles and no two bond structures are exactly alike.

Contrast this with the Treasury market, a market dominated by **institutional** investors. At \$10.2 trillion, the Treasury market is nearly three times the size of the municipal market, but consists of a **single issuer** and less than **300 separate bond issues**. And because all Treasury securities carry the "full faith and credit" guarantee of the U.S. government, there is only **one credit profile** and it is **risk-free**. Consequently the only difference between one Treasury bond and another is the coupon and maturity. This is not the case with municipal bonds, where **no two bonds are alike**. From general obligation bonds to dedicated revenue bonds, rated to non-rated, insured to non-insured, bank qualified to AMT eligible, callable, puttable, pre-refunded and "sinkers", there is simply no such thing as a "generic" municipal bond.

And it is because each issue is **"unique"** that municipal bonds are traded in the **over-the-counter (OTC)** market rather than on an organized exchange. In an organized exchange, such as the New York Stock Exchange, all traded securities are "listed" so that many buyers and sellers can arrive at a **single price** based on an auction process of competitive "bid" and "ask" levels. The presence of many buyers and sellers competing for securities in a central location on the basis of a highly visible price, makes for a very liquid and efficient market. In stark contrast, buying and selling in the OTC market occurs via a network of "middlemen", called dealers, who carry limited inventories of securities that they price and then try and sell to investors. Trading takes place directly between two-parties, with prices determined on a negotiated basis. Because there is no central exchange for municipal securities, **a single visible price does not exist for individual bonds**. And because most municipal bonds are owned by **"buy and hold" individual investors**, most bonds do not trade for long periods of time, greatly reducing liquidity and real-time price information. This type of market breeds inefficiencies that are reflected in security prices yields. However, for managers who understand the nuances of both the unique market and the securities, these inefficiencies represent opportunities to add value to municipal portfolios.

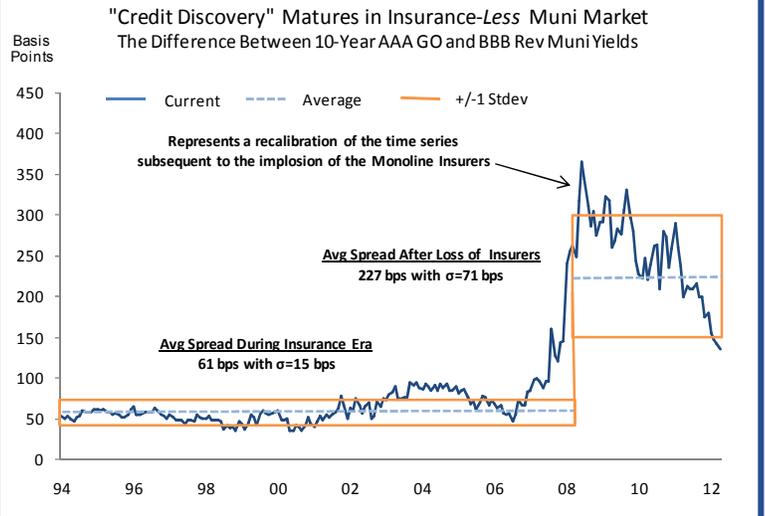
The first question we must consider with respect to maximizing purchase yield, is **what to buy**. While there are clearly a multitude of considerations that go into this determination, we are only going to consider one aspect of this decision for purposes of illustration. **How much credit risk should be taken to increase the purchase yield on**

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the portfolio? Referring to **Figure 2**, we can see that prior to the Great Recession of 2007-08, the credit or risk-spread between AAA and BBB 10-year municipal revenue bonds averaged **61 basis points** with annual average volatility of just **15 basis points**. (AAA and BBB represent the highest and lowest credit quality ratings within the investment grade universe) As such, for investment grade bonds, **61 basis points** represented the maximum increase in yield that you might obtain, on average, by increasing credit risk in an investment grade portfolio. By way of contrast, the same risk-spread available in the corporate market for the same time period averaged **93 basis points** with an annual average volatility of **49 basis points**. Risk spreads for corporate bonds were approximately **50 percent higher** than for municipal bonds. However, the average annual volatility of corporate risk spreads was over **three times** that of municipals, indicative of a degree of complacency wholly unsuited to the unique and non-homogenous nature of municipal bonds. As it turns out, much of the lower risk spread and volatility between corporates and municipals was attributable to market reliance on **bond insurance**. Referring again to **Figure 2**,

Fig 2 What is the Price of Risk in Terms of Yield?



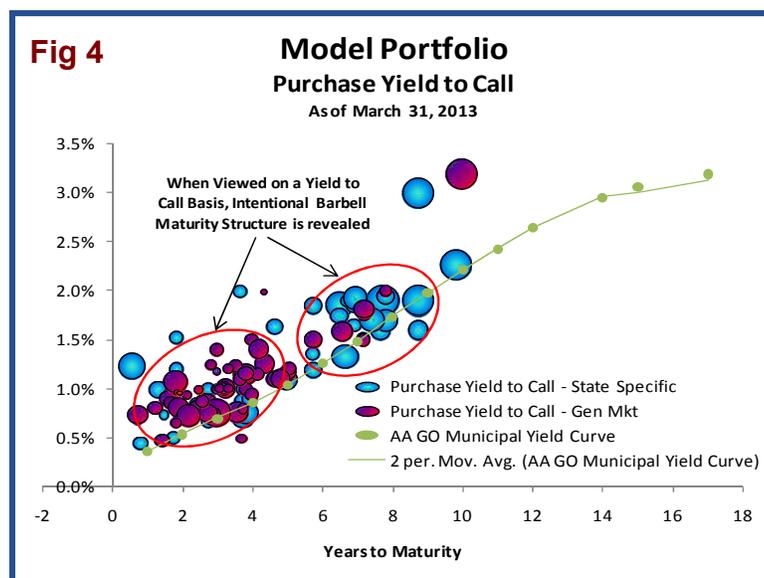
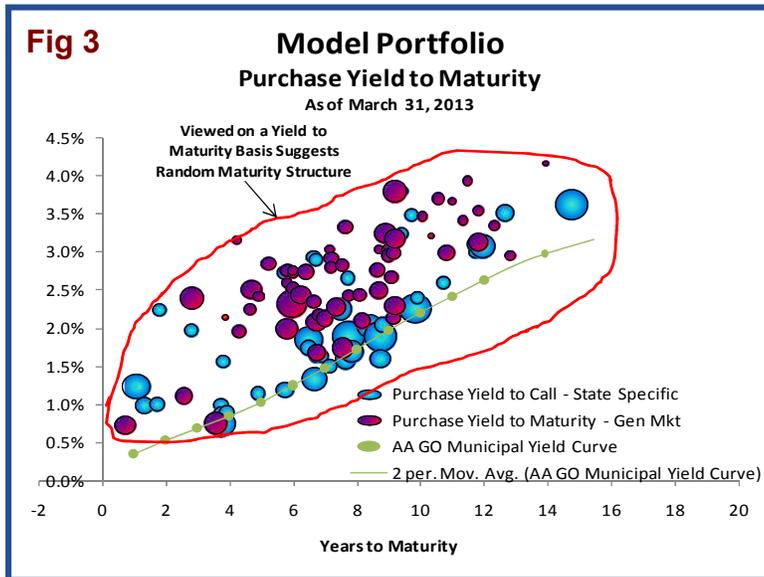
we can see that subsequent to the loss of the **monoline insurers** in 2007, risk spreads on municipals exploded to levels **over 350 basis points**, averaging around **235 basis points** since that time. More importantly however, the average volatility has increased nearly **five-fold** to over **70 basis points**. We have often referred to this recalibration of credit risk in the municipal bond market as the new era of "**credit discovery**." Prior to the loss of the insurers, over **one-half** of all municipal bonds carried bond insurance and as a result, risk spreads did not accurately reflect the true risk level of the underlying credit profile of the issuer. It was not uncommon for investors to simply rely on the credit rating assigned by the rating agency, giving no real attention to the unique nature of the credit profile of the issuer or the unique structure of the bond itself. As illustrated by the increase in the level and variability of municipal risk spreads, the days of cavalierly ascribing to monolithic assessments of credit quality by ratings agencies is over. In the new era of credit discovery, careful attention must be given to a proper assessment of credit risk, taking all the unique nuances of municipal bonds into consideration before blindly reaching for higher promised yields. This is a case where more is not unambiguously more.

The next question we must consider with respect to maximizing purchase yield, is **when to buy**. By "when" we are not referring to a time to buy, but rather "when" to buy on the yield curve; **How much interest rate or duration risk should be taken to increase the purchase yield on the portfolio?** Again as this is a very involved topic, we do not want to represent our discussion as comprehensive, rather we want to simplify the discussion for purposes of illustration. Just like the question of credit risk, most people are aware that, generally speaking, the longer the bond's time to maturity, the higher the purchase yield received. (For purposes of this discussion, we will ignore the special problem of an inverted yield curve) The question of how much interest rate risk involves a combination of art and science. Clearly one needs to have a rudimentary understanding of bond mathematics, total

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return horizon analysis and the term structure of interest rates to properly assess the potential impact of changes in interest rates on portfolio value. However, to this, one must apply, wittingly or unwittingly, a value judgment on the probable evolution of interest rates and the reshaping of the yield curve across time. Referring to **Figure's 3 and 4**, we illustrate the application of this art and science to the construction of an actual client portfolio. Both charts illustrate the same client municipal bond portfolio with each bubble representing an individual issue. The horizontal or X-axis represents the years to maturity of each issue with the vertical or Y-axis representing the purchased yield on the bond. The size of each bubble represents the relative par value purchased, while the color indicates whether the bond is state specific or general market. The green line represents the moving average of the AA GO municipal yield curve during the period the portfolio was constructed, acting as a proxy for the market yields offered. The only difference between the two charts is that **Figure 3** graphs the **purchase yield to maturity** on the bonds, while **Figure 4** graphs the **purchase yield to call**. Looking only at **Figure 3**, it would appear that the bonds were **laddered randomly**, with no particular bias or judgment applied with respect to interest rate or duration risk in the portfolio. Not unlike throwing darts, the portfolio appears to have been constructed based solely on the random nature of the bond offerings available when the portfolio was constructed. However, when we look at **Figure 4** and consider the construction of the portfolio when viewed through the lens of **purchased yield to call**, the **intentionality of the portfolio construction** becomes apparent. Notice the purchases are tightly clustered around two different areas of the yield curve, reflecting the **barbell construction** of the portfolio. Generally speaking, a barbell portfolio is desirable as a defensive structure against rising interest rates and in particular, a bearish steepening of the yield curve. To attain this structure requires a strategic decision to **forgo some additional yield** in the form of term premium in order to hedge against a rising yield curve. In addition, the location of each of the barbell concentrations is not random either, but reflects a strategic decision regarding the overall interest rate risk in the portfolio (parallel duration),



the portfolios level of non-parallel exposure to specific yield curve reshaping, and toward optimizing prospective curve roll from portfolio aging. Importantly, those bonds in the short-barbell area represent prospective near-term cash flows that will have to be actively invested again. Notice also the significant difference in purchased yield levels over the offered levels in **Figures 3 and 4**. Looking solely at the yield levels to maturity in **Figure 3**, the portfolio appears to have captured an excessive yield premium over offered yields. This reflects the fact that most of those attractive yield levels to maturity are **"throw-away yields"** meant to entice the investor into believing he has locked in abnormally high purchase yields. In fact these yields will never be realized as the bonds will be called prior to maturity. In the municipal market, it is always caveat emptor.

The final question we must consider with respect to maximizing purchase yield, is **where to buy**. Specifically, the question of **from whom to buy municipal bonds** directly addresses the myth that because there is no **called-out commission**, buying municipal bonds is **"costless."** Of the three areas, this is perhaps the most important as it is the least visible and the least understood and yet has the greatest potential impact on portfolio return. Because the purchase yield of a portfolio has a significant, but not a determinative impact on prospective portfolio returns, any unnecessarily **"lost purchase yield"** is an error that compounds over the long life of the portfolio. Because municipal bonds trade in an over-the-counter (OTC) market, a single visible price does not exist for municipal bonds. Trading takes place directly between two parties with prices determined on a **negotiated basis**. As such, the broker-dealer does not charge a **"called-out commission"**, instead the B/D marks up the price of the bond offered for sale. This **markup** in bonds prices is the greatest of the **unknown unknowns** to the individual investor. He simply does not know how much he is paying in the markup of the price of a bond issue, and hence how much purchased yield he is permanently losing. Markups, or the difference between the dealer cost and the offered price of the bond, represents the dealers "profit" on the trade. Markups of **2 to 3 percent** on municipal bonds are common, often because bonds are marked up or **"stepped on"** multiple times in interdealer trades before finally being sold into a portfolio. At Redstone, we actively manage the dealer markup, striving to reduce the markup paid to less than **0.50 percent**. At Redstone, we won't be "stepped on".

Ultimately the proper construction of a high quality buy-and-hold municipal portfolio is not, as is popularly believed, an exercise in **yield at any cost**, it is rather an informed and intentional process of determining **at what cost, yield**. Simply buying the highest yield ignores any applied judgment about credit risk, interest rate risk and the reality of permanently lost yield in the form of price markups. At Redstone we understand the unique nature and the nuances of both the securities and the market. Unfortunately this is something that can really only come from experience and time in the municipal market. With nearly 25-years of hands-on experience in the municipal market, this is an area where we believe that we can consistently add yield and value to client portfolios.

Fig 5

AA General Market Yields

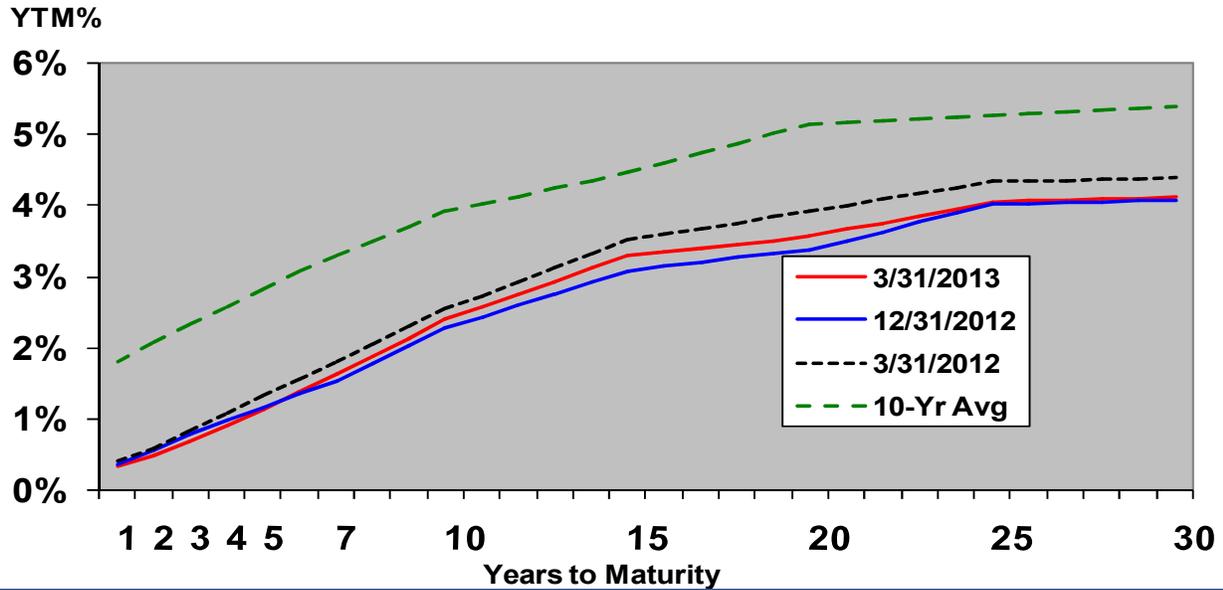
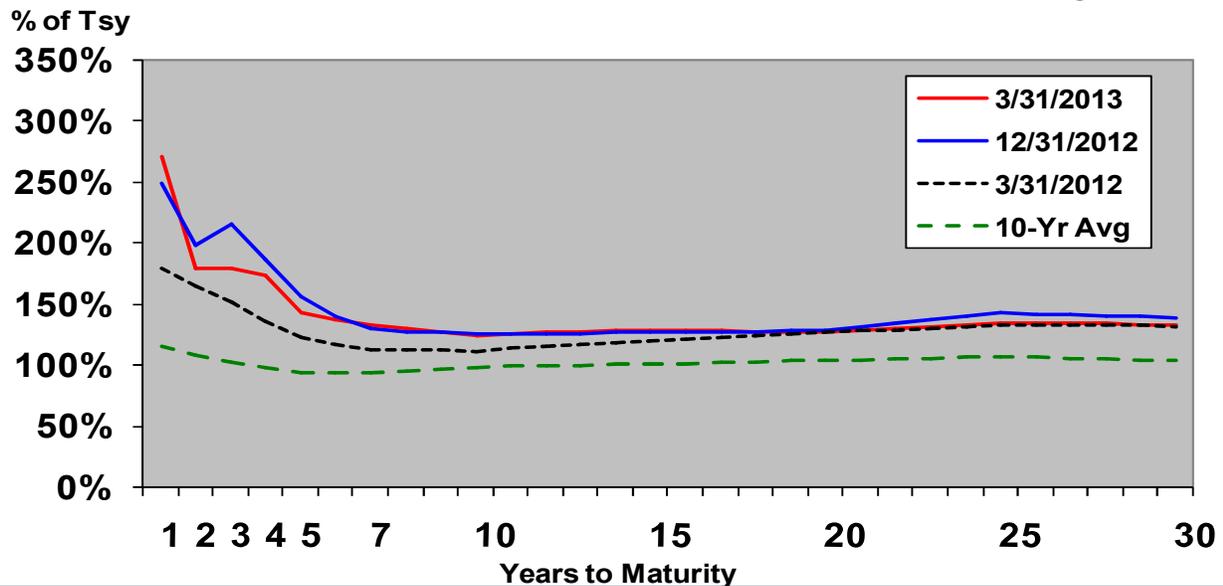


Fig 6

AA General Market Yields as % of Treasury



	10 Yr Avg	12/31/2012	3/31/2013
2-Year AA Municipal	107%	198%	179%
5-Year AA Municipal	93%	156%	143%
10-Year AA Municipal	97%	125%	124%
25-Year AA Municipal	106%	142%	134%