

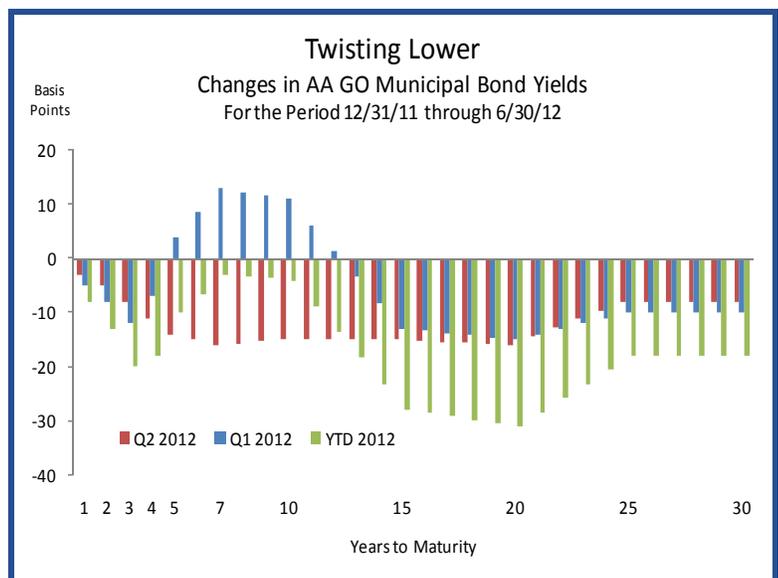


## Municipal Market Review

Second Quarter 2012

Municipal bond yields rallied again during the second quarter of 2012, bringing the total number of consecutive quarters in a row that municipal yields have declined to **six** going all the way back to the fourth quarter of 2010. That, not coincidentally, coincides with the now infamous prediction by a well known analyst in December of 2010 for “*hundreds of billions of dollars*” in municipal bond defaults during 2011. Time for a *mea culpa*. To quote Emily Litella of SNL fame, “*never mind.*” Referring to **Figure 6**, we can see that while yields declined modestly across the entire curve, with the intermediate area of the curve experiencing the largest declines. Given the relatively modest changes in municipal yields year-to-date as reflected by the close proximity of the three yield curves in the chart, the specific reshaping of the curves is better reflected in **Figure 1** which graphs the changes in municipal yields by each maturity for the first and second quarters of 2012 and well as for the YTD period through June 30, 2012. As we can see in **Figure 1**, after experiencing a slight downward butterfly shift during the first quarter (**blue bars**), the municipal yield curve underwent a “**parallel shift downward**” in yields (**red bars**) during the second quarter resulting in a slight bullish flattening of the yield curve. Specifically the 2s-to10s segment of the yield curve flattened by 10 basis points, from 196 basis points to 186 basis points, while the 10s-to-30s segment steepened by 7 basis points, from 184 basis points to 191 basis points. Overall, the municipal yield curve, as measured by the 2s-to-30s segment, flattened by 3 basis points, from a level of 380 basis points to 377 basis points during the second quarter. For the first six months of 2012, municipal yields stand lower across the entire yield curve. Due to the ongoing **six-quarter rally** in municipal yields since the end of 2010, the **opportunity cost** of holding cash, as measured by the yield pick-up between 3-month yields and 5-year yields, has fallen markedly. At the end of 2010, an investor could pick-up approximately **150 basis points** (1.50%) in additional yield by investing in a 5-year bond versus cash. Today an investor only picks-up around **80 basis points** (0.80%). The supply of new issue municipal bonds is up **60 percent** over last year. Nevertheless the market’s technical backdrop continues to be supported by **strong demand** as investors continue to be drawn to municipal bonds for its lower relative volatility, **high quality income stream** and its **capital preservation attributes**. Finally, as reflected in **Figure 7**, the **relative value ratios** of municipals to Treasury’s, remains **above 100 percent**.

Figure 1

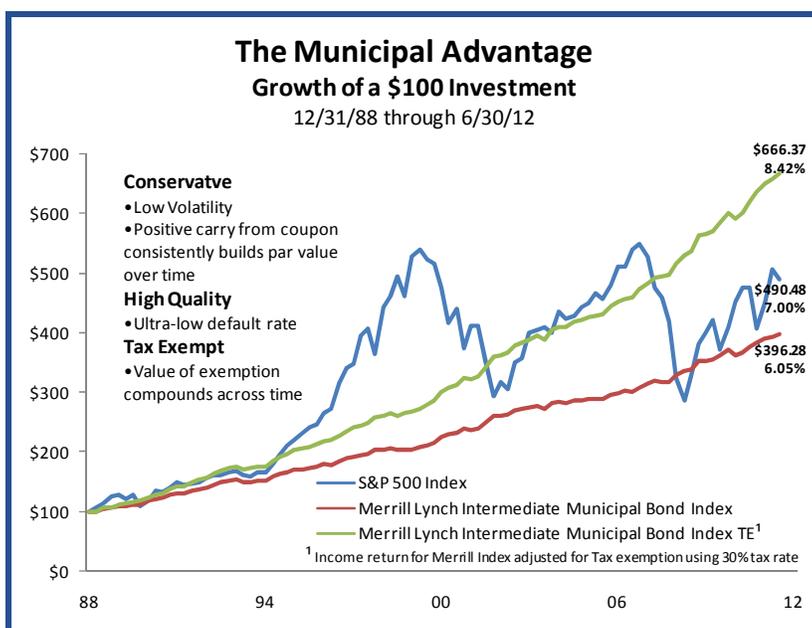


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One question that we are frequently by asked by prospective investors these days is “*why should I own municipal bonds?*” We thought it would be appropriate to offer some answers. We believe that the cornerstone of wealth management should be **capital preservation**, not capital appreciation, and as such, we believe municipal bonds are uniquely suited to achieve that goal. **Figure 2** illustrates the growth of a \$100 dollar investment in stocks as represented by the S&P 500 Index, versus an investment in intermediate high quality municipal bonds as represented by the Merrill Lynch Intermediate Municipal Index. The investment in the Municipal Index is presented on both a nominal basis as well as a tax-equivalent basis. This is done by adjusting the income return on the Municipal Index for the effect of the **tax-exemption** on municipal bonds. (A 35 percent federal tax rate is assumed) The investment begins on December 31, 1988 and continues through June 30, 2011. The purpose of this comparison is not to suggest that over time, one asset class will always outperform the other. Rather it is simply to illustrate **three characteristics**

**Figure 2**



of municipal bonds which make them uniquely suited for the role of capital preservation.

First they represent the **conservative approach** to investing in capital markets. Specifically we are referring to their attributes of **positive carry**, **predictable cash flows**, and **lower volatility**, all of which enable municipal bonds to **build par value across time**. And building par value is the primary long-term goal of portfolio management. Referring to **Figure 2**, we can see that contrary to stocks, the return pattern of the investment in intermediate municipal bonds tends to **rise consistently** across time without the sharp swings in periodic returns which accompanied an investment in stocks. This is owed primarily to the fact that a substantial portion of the bond’s return is “**guaranteed**” in the form of an income component from the bond’s coupon, rather than from a change in price due to a change in underlying market conditions. Not only is the **coupon contractually** guaranteed, but it is also paid on regular and predictable intervals, providing the investment with a **positive carry**. Additionally by focusing on intermediate maturities, **price volatility** due to changes in market interest rates is dampened. Finally, **reinvestment income** on recurring coupon cash flows, also acts to further reduce return volatility. All of these attributes contribute to building par value and capital preservation.

The second characteristic is the **high credit quality** of municipal bonds. Referring to **Figure 3**, we can see that virtually all municipal issuers have an **investment grade rating**, with over **85 percent** of the issuers rated single-A or higher. By comparison, only **37 percent** of corporate issuers are currently rated single-A or better. Municipal bonds as an asset class

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have the **lowest overall default experience** of any Treasury debt sector. According to a study by Moody's, for the 40-year period between 1970 and 2009, there were only **54 defaults** of Moody's-rated municipal issuers, with **51** of the defaults occurring in **non-GO debt** and **42** of the defaults occurring in the **healthcare** and **housing project finance sectors**. Additionally, the average 10-year cumulative default rate for single-A municipal bonds over the period reviewed (all sectors), was only **0.03%**. For GO debt, the same rate was **0.00%**. Contrast this with single-A corporate debt which had an average 10-year cumulative default rate of **2.05%**. Municipal government debt secured by a **"general obligation" (GO) pledge**, legally provides that all of the revenue-producing power of a municipality can be applied to service the debt, including the municipalities ability to **levy**

**additional taxes**. In addition, **essential service revenue debt**, such as sewer and water revenue issues, have specific revenue streams contractually pledged to the payment of the debt they secure. Rather credit risk in municipals is concentrated in the **high-yield sectors** such as corporate industrial revenue bonds, development district bonds, housing sector bonds, and debt issued by the healthcare/nursing home sector. While still "labeled" municipal bonds, it is much more accurate to refer to these bonds as **corporate bonds** in a **municipal wrapper**. Those are sectors that we typically do not utilize.

The third characteristic is the **tax-exemption** available to investors on the interest earned on municipal bonds. Generally speaking, the interest income on municipal bonds is exempt from federal income tax and is also exempt from state income tax on bonds issued by the home state in which the investor lives. As such, for states which levy an individual income tax, interest income on bonds issued by the state in which an

Figure 3

non-

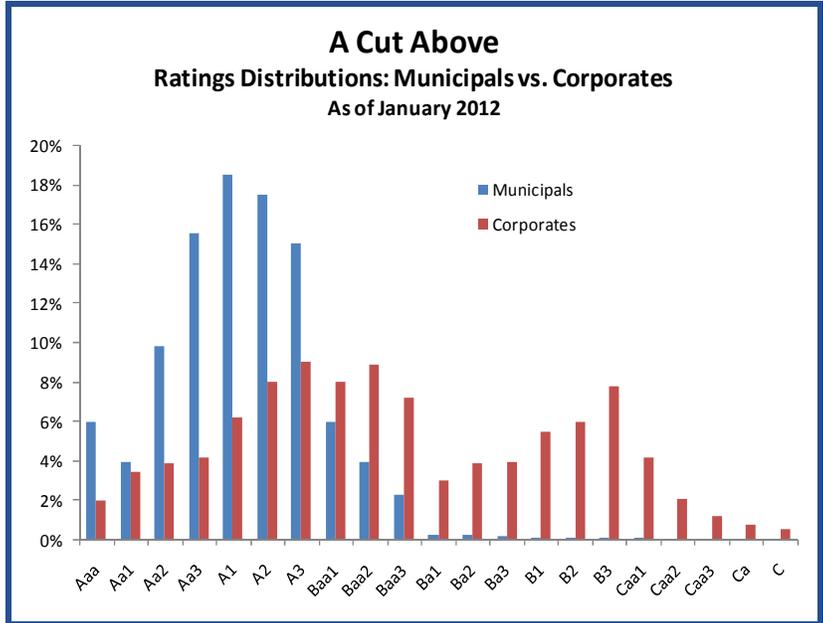
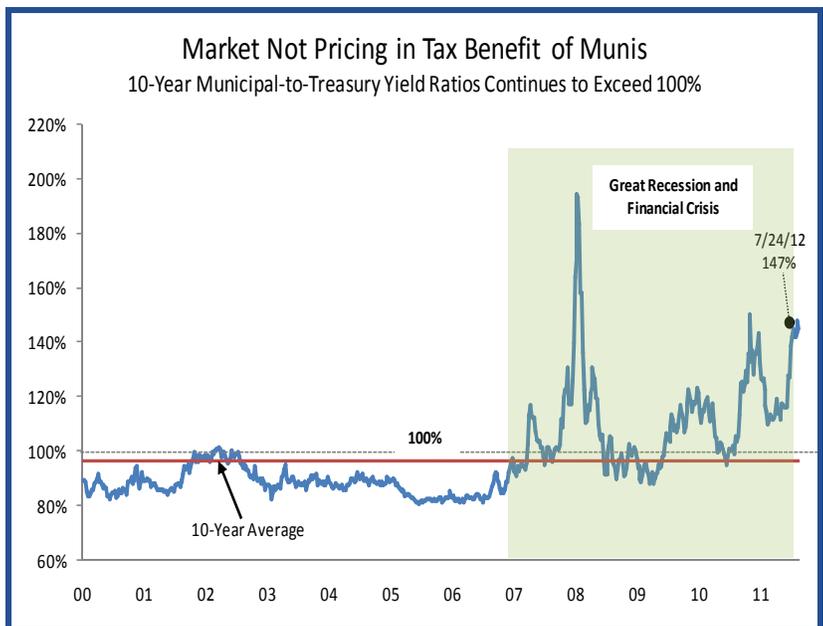


Figure 4



investor is domiciled are said to be **“double-exempt”**, further leveraging the value of the tax-exemption. Over time, the value of this important, yet often overlooked characteristic of municipal bonds can be significant. This is reflected in **Figure 2** where we can see that across the nearly 24-year period covered, the **compounded value of the tax-exemption** on the interest earned, increased the terminal value of the investment from \$396.28 to \$666.37, an increase of approximately **68 percent**. Referring to **Figure 4**, we can see that municipal bonds continue to out yield Treasury bonds on a before-tax basis. This implies that the market is effectively discounting the entire value of the tax exemption to investors. As we can see, at **147 percent**, the current ratio of the 10-year municipal-to-Treasury yield remains well above its 10-year average of **97 percent**. Given the very real value of the interest exemption to investors, municipals should trade at yields less than 100 percent of Treasury yields. And as reflected in **Figure 4**, prior to the onset of the financial crisis, they did. However since the start of the crisis, municipal yields have been consistently higher than Treasury yields, due in part to the massive **“flight to quality bid”** that has driven Treasury yields to historic lows. And given the Fed’s public commitment to keep rates low for an extended period of time, the municipal tax exemption will continue to be an important source of leverage to the income return component of municipal bonds. Importantly, the tax exemption, like the coupon payments, is contractual and as such, it is not affected by movements in market interest rates, thereby acting to **dampen return volatility** and promote the building of par value through consistent, contractual cash flows. These characteristics, a conservative approach to building par value, very high credit quality and a tax-exempt status, make municipal bonds uniquely qualified for the preservation and appreciation of that portion of an investors net worth that should not be exposed to excessive market risk.

Of course, understanding risk is an important consideration. We believe traditional **“risk measures”**, which rely solely upon a mean and variance framework to describe uncertainty in a distribution of investment returns, are **fundamentally flawed** in that these measures equate variability, or **volatility with risk**. A fundamental tenet of Modern Portfolio Theory is the notion that portfolios should be constructed in a way that generates the highest possible expected return, given the level of “risk” assumed. In this context, risk is defined as the variability of periodic returns compared to the average return over time, i.e., the **standard deviation**. In essence, standard deviation measures the **risk of not achieving the average return**. And while there are applications where this statistic is useful, in our opinion it falls woefully short of measuring investment risk. **Investment risk, properly defined, is the risk of loss – period!** Volatility is by definition, temporary and mean-reverting, reflecting the temporary increase or decrease in the market value of the investment. An investor does not lose money merely because the market price of his holdings decline. By contrast, a **risk of loss** represents a **permanent reduction** in investment value, the occurrence of which is neither mean reverting nor statistically predictable. For this reason, we believe that during times of increased uncertainty, such as those we are currently experiencing, **the severity of the consequences** – the possibility of a permanent loss, – **not the probability of occurrence, should drive the risk decision**. Given the high level of credit quality of municipal bonds, coupled with the fact that they represent a contractual obligation of the issuer, municipal bonds are uniquely qualified to meet Benjamin Graham’s classic investment definition: **“An investment operation that upon thorough analysis, promises safety of principal and an adequate return.”** This, in our opinion, continues to be the proper perspective for investment risk and return.

However, the message from the current market is that **investors are scared** and **income is scarce**. As we noted earlier, since the onset of the financial crisis, bond yields have fallen sharply, with safe haven Treasury yields falling below municipal yields, causing the relative yield ratio of municipals to rise above 100 percent (**Figure 4**). As an investor, from a

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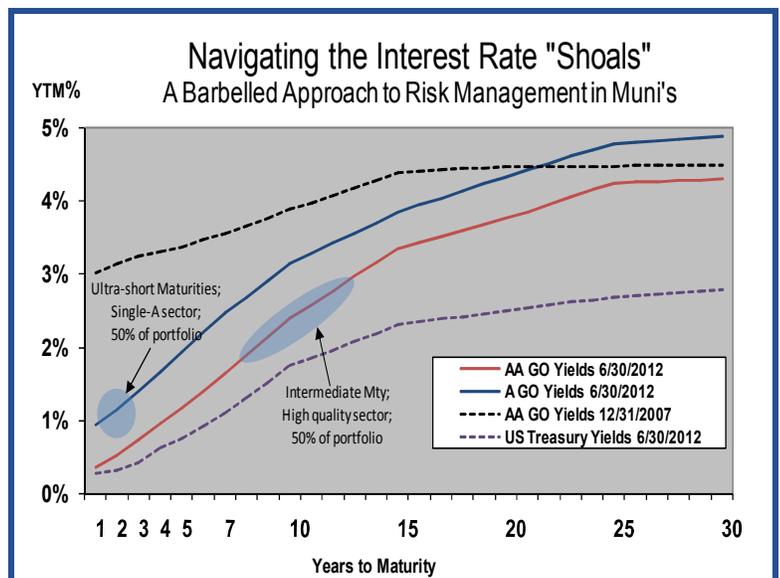
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valuation perspective **you want to own what is scarce**, and bonds that offer a **high quality income stream** are scarce. In addition, demographics are exacerbating this **scarcity of income**. As baby-boomers are retiring and de-levering, they are increasing their demand for a high quality income stream. This is an environment that clearly favors municipal bonds.

Of course, one might ask **why invest in bonds at these historically low yield levels?** While it is true that municipal bond yields are at levels not seen in over 40 years, for the reasons already discussed, the conservative attributes of municipal bonds, coupled with the abnormally high relative level of municipal yields compared to Treasury yields and the compounding value of the tax exemption, municipal bonds still offer good relative value in this market. And while the Federal Reserve has repeatedly emphasized their commitment to a **zero interest rate policy** (ZIRP) through at least 2014, complacency is another risk that should be guarded against. Clearly the most likely course is for **interest rates to remain low** and the **yield curve to remain relatively steep**, nevertheless the risk of a cyclical rise in interest rates should not be ruled out. For this reason we would recommend the use of a modest **barbell structure** in the construction of new portfolios. This structure is reflected by the blue-shaded circles in **Figure 5** which represent the location along the respective yield curves where an investor could position his portfolio. The barbell would consist of a combination of ultra-short holdings located in the **1-to-3 year** segment of the **single-A credit curve** coupled with intermediate holdings in the **7-to-12 year** segment of the **AAA and AA credit curve**. The use of ultra-short single-A securities would allow an investor to double his purchased yield in this area, picking-up over **50 bps in yield** versus comparable maturities in the AA credit sector, while effectively negating any incremental credit risk due to the short final maturities used. The intermediate holdings in the **higher quality sectors** would allow an investor to lock-in a substantial **term premium over cash**, taking only moderate interest rate risk while **minimizing credit risk**. The dotted black and purple lines on the chart represent possible **outlier levels** of future interest rates. Over time, the short-term holdings will mature and be re-priced at market yields. If interest rates are rising, the short duration of these holdings will **mitigate interest rate risk** in the portfolio while allowing the investor to increase his purchased yield on the re-invested securities. At the same time, the intermediate holdings will offer a term premium, curve roll and prospective capital gains should interest rates remain steady or continue to decline.

So should you own municipal bonds? When you consider the unique characteristics of municipal bonds coupled with the fact that the current unprecedented market environment of low nominal rates and heightened uncertainty is likely to last for several more years, we believe municipal bonds are the choice *par excellence* for building par value and preserving wealth.

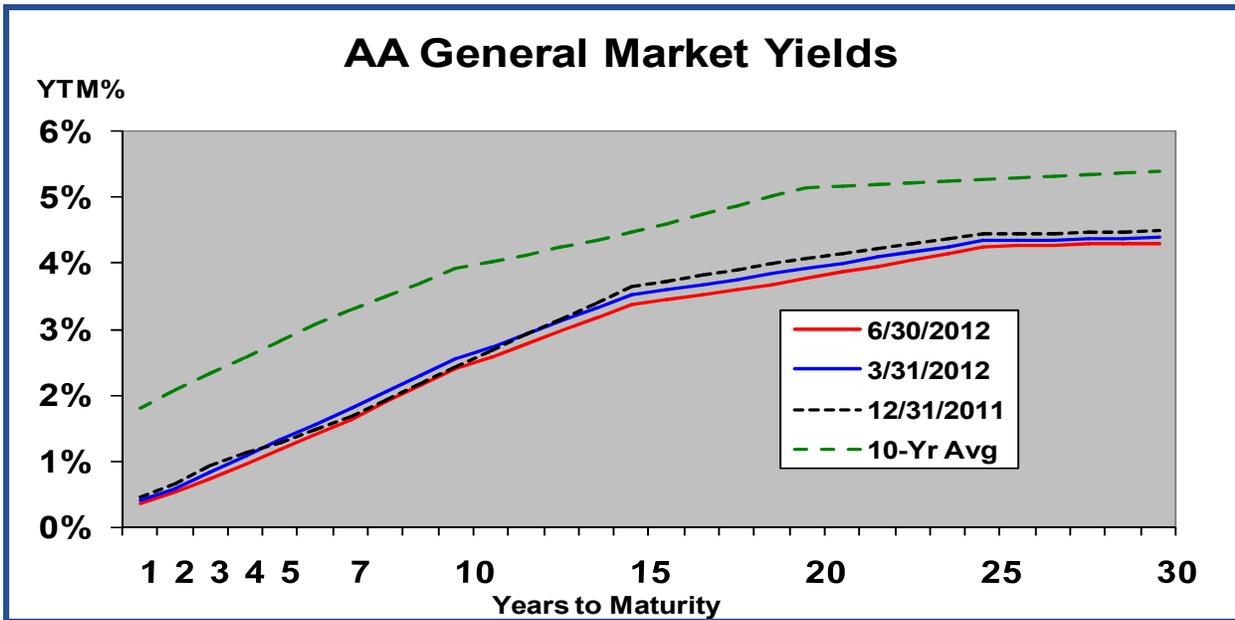
**Figure 5**



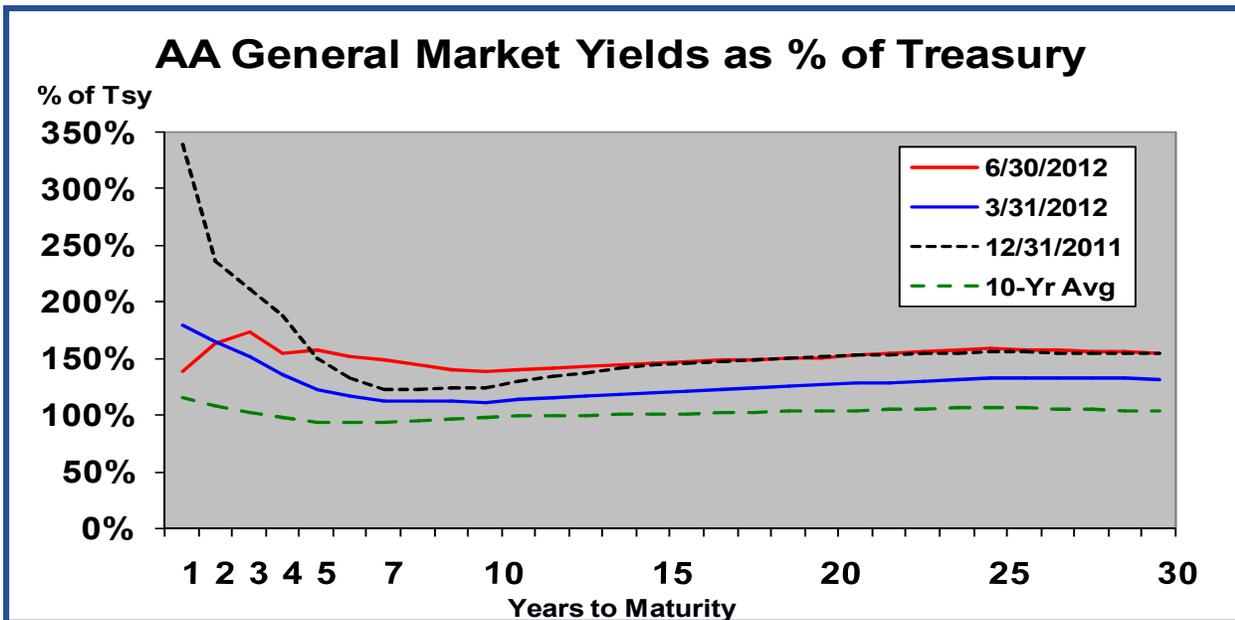
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**Figure 6**



**Figure 7**



	10 Yr Avg	3/31/2011	6/30/2012
2-Year AA Municipal	107%	164%	162%
5-Year AA Municipal	93%	127%	157%
10-Year AA Municipal	97%	111%	137%
25-Year AA Municipal	106%	133%	158%