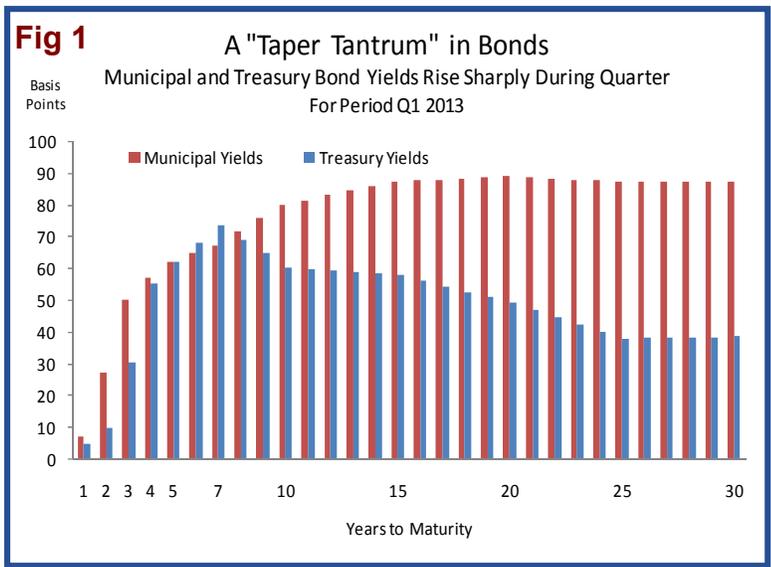




Municipal Market Review

Second Quarter 2013

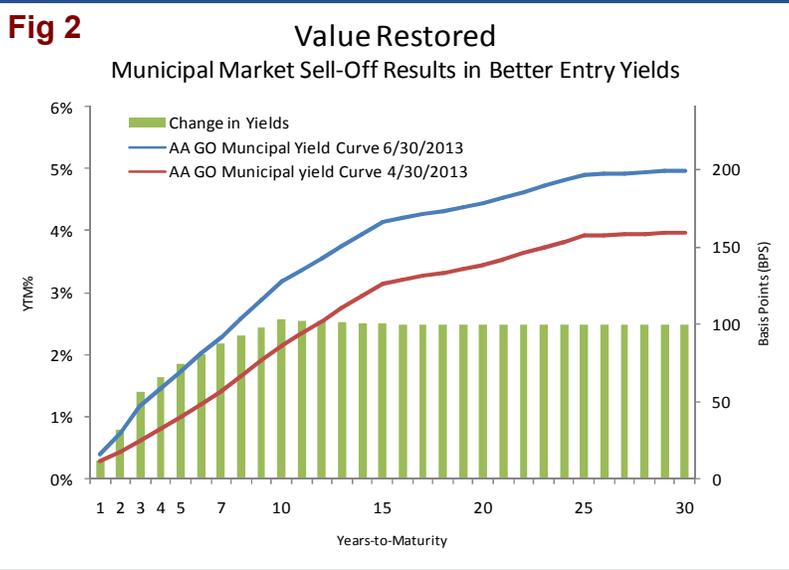
Heading into the second quarter, the backdrop for municipal bonds continued to be extraordinarily low bond yields coupled with continuing inflows into municipal bond funds. However, after a slight rally in April, what began in May as a modest rise in interest rates, escalated into a full-blown **"taper tantrum"** during June, replete with falling stock prices and rising bond yields. The sharp rise in yields was an event wholly precipitated by the Federal Reserve's **"taper talk"**, not a credit-driven or municipal market specific event. This can be seen in **Figure 1**, where we can see that for the quarter, yields on both Municipal and Treasury bonds increased markedly, with municipal yields rising more than Treasury yields for maturities greater than 10 years. As a result, municipals, on a duration neutral basis, underperformed their Treasury counterparts for both the month of June and the entire quarter. The loss posted by municipal bonds for the second quarter, brought to an end the municipal market's nine-quarter positive return streak. As a result, the two year period of strong inflows into municipal bonds, reversed with heavy outflows in late June and early July. Referring to **Figure 7**, we can see that municipal bond yields rose all across the yield curve, ending the quarter substantially above both first quarter 2013 levels as well as year-end 2012 levels. In addition, intermediate and long-term yields rose more than short-term yields, resulting in a bearish steepening of the curve. Due to the rise in yields, the 2s-to-10s segment of the yield curve steepened by a very noticeable **53 basis points**, while the 10s-to-30s segment steepened by only **7 basis points**. Overall, as measured by the 2s-to-30s segment, the municipal yield curve steepened by **60 basis points** to a level of **422 basis points** and as such, remains extremely steep when compared to the 10-year average of **333 basis points**. While painful, the **"taper tantrum"** has acted to **restore value** in an overbought market, particularly in the intermediate and long-term maturity sectors. This is reflected both by the **higher entry yields** available across the municipal yield curve, as well as the increase in **municipal relative value ratios**. The effect of the reshaping of the municipal and Treasury yield curves on relative value ratios is reflected in **Figure 8**, where we can see that aside from a modest decline in the 3-to-8 year segment of the yield curve, municipal relative value ratios rose for all other maturities during the quarter. As such, municipal bonds remain quite attractive as relative value ratios remain both above 100 percent, and their 10-year average for all maturities. Beneficially, this sell-off has opened a **window of opportunity** in which to deploy capital at **higher entry yields** for those who are positioned to do so.



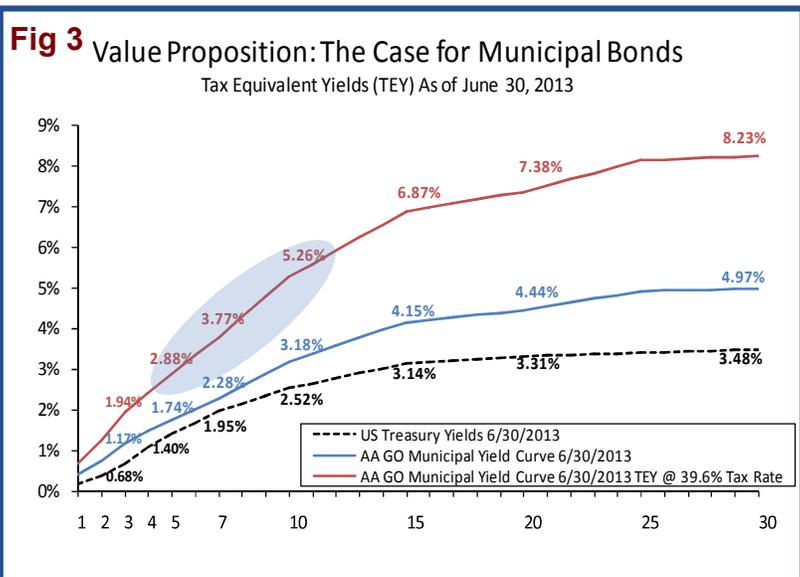
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This "window" can be readily seen in **Figure 2** which compares AA GO municipal yields for the periods ended June 30, 2013 and April 30, 2013, and the change in yields between those dates in basis points. After rallying for eight consecutive quarters, the back-up in interest rates during May and June helped to **restore value** in municipal bond yields. As a result, **entry yields** have risen markedly across the entire yield curve, with 5-year, 7-year and 10-year yields rising 75, 87 and 103 basis points respectively. On a nominal basis, this represents a substantial increase to an investor's **purchase yield**. This is important since for buy and hold investors, the entry or purchase yield is the most important determinant for prospective long-term returns as over longer horizons, the cumulative accruals from the income component will come to dominate the total price effects.



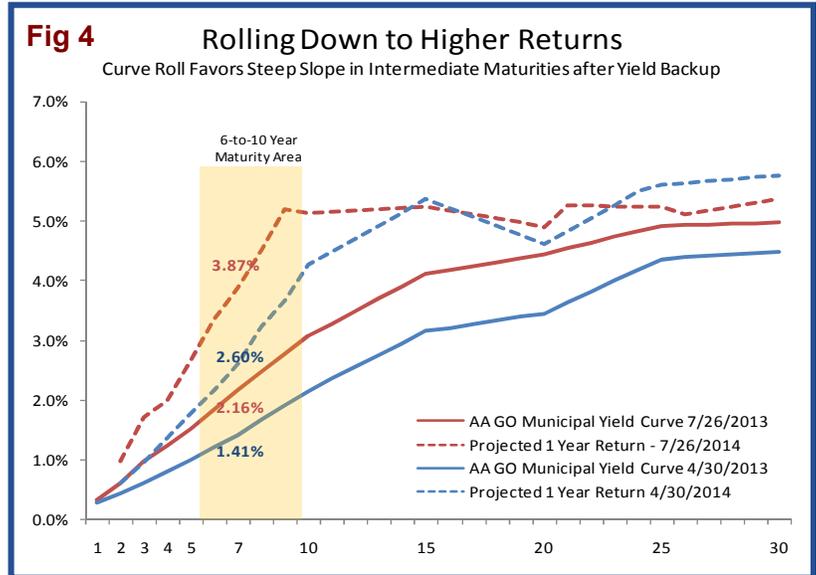
However, far too often investors focus solely on nominal yields in the determination of value and fail to consider the "real value" inherent in high quality municipal bonds, their **tax exemption**. The value of the tax exemption also "benefitted" from the rise in bond yields during the quarter. As such, a 5-year municipal bond, which after the backup in yields, is now priced to yield around 1.74 percent on a nominal basis, currently offers a **288 basis point increase** over the current cash yield of zero on a tax equivalent basis. (**Figure 3**) Likewise, a 10-year bond priced to yield 3.18 percent, offers a **526 basis point pick-up** over cash when yields are tax adjusted. It is also important to remember that value of the interest exemption in an investor's portfolio compounds over time, which can have a significant impact on the growth of a portfolio's value across time. By way of example, due to the power of compounding, a 3.5 percent yield over 15 years, has a terminal value 32 percent higher on a tax adjusted basis than a nominal 3.5 percent yield. Given Einstein's insight regarding "compound interest as the most powerful force in the universe", clearly any high-quality investment with a built-in yield enhancement of up to 35 percent should be a part of every investor's long-term investing strategy.



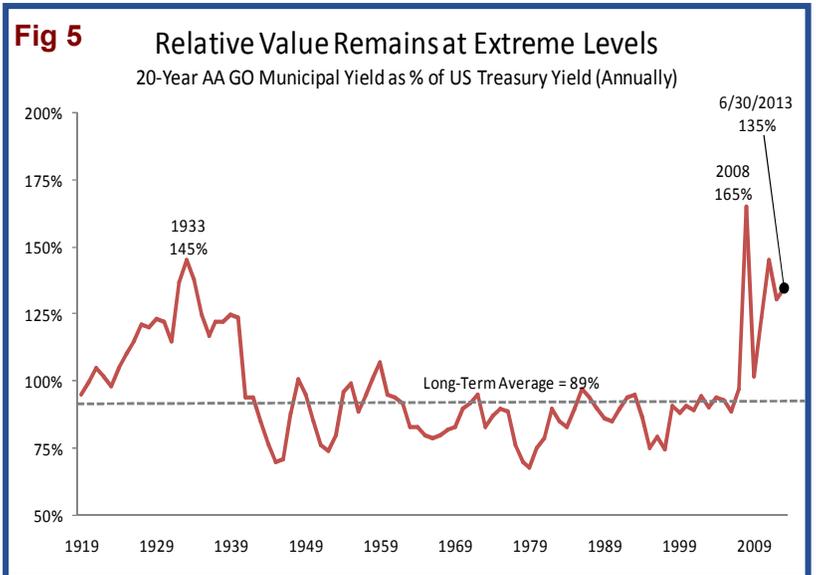
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Another not-so-insignificant "benefit" to investors from the back-up in municipal bond yields is that by causing the yield curve to steepen, the "roll value" or additional return due to aging, has increased markedly. This is illustrated in **Figure 4** which graphs the both the April 30 (blue line) and June 30, 2013 (red line) yield curves and their respective projected 1 year total returns for each maturity. (dotted lines) By holding bond yields unchanged over a simulated 1-year holding period, we can isolate the potential increase in total returns attributable solely to curve roll. As we can see, curve roll has the greatest potential impact on those maturities in the area denoted on the chart by the highlighted rectangle or the 6-to-10-year maturity area. In addition, we can see that subsequent to the rise in bond yields, projected 1-year returns as reflected by the red dotted line, have increased substantially relative to the April 30, 2013 projection, due to the increased return from curve roll. For example, the projected 1-year return for a 7-year AA GO municipal bond increased from 2.60 percent to 3.87 percent, a 49 percent increase in projected return due to the widening in the annual yield drops. As such, we can see that the steepest part of the curve offers the greatest incremental return per unit of interest rate risk. We continue to favor this area of the yield curve, both from a relative value perspective as well as from a defensive posture.



Despite the fact that most bond yields rose during the "taper tantrum" of the second quarter, the relative value of municipals, as measured by the ratio of municipal yields to Treasury yields, remains at historically high levels. **Figure 5** illustrates the relative value ratio of the 20-year municipal bond versus the 20-year Treasury bond on an annual basis since 1919. As we can see, despite the modest decline from its all time high of 165 percent reached during the height of the financial crisis in 2008, this measure of relative value, at 135 percent, remains over 50 percent higher than its long-term average of 89 percent. Ominously, the levels seen since 2008 were only equaled during the nadir of the Great Depression. Nevertheless, at current elevated levels, municipal yields continue to offer good relative value.



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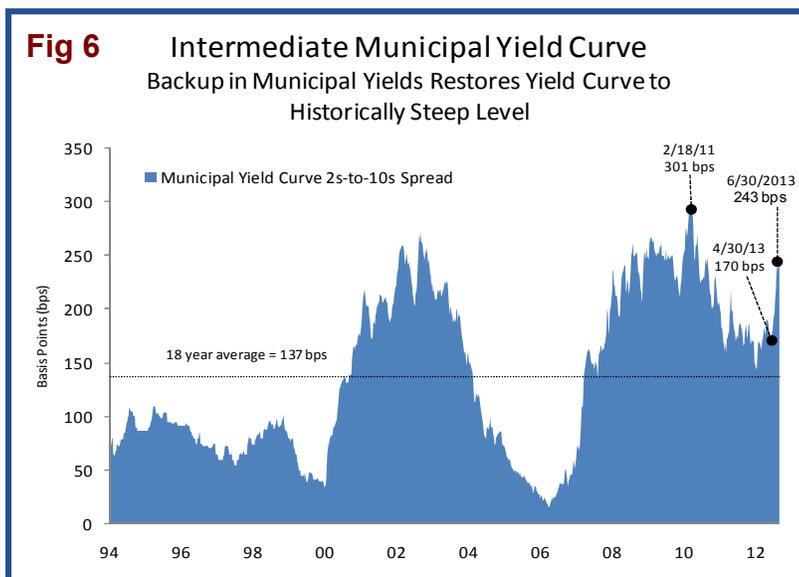
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Aside from good relative value, municipal yields offers investors the opportunity to lock in **good absolute value** by **extending maturities** out the yield curve from cash. As previously mentioned, the backup in yields during the quarter resulted in a **marked steepening** of the municipal yield curve.

Figure 6 illustrates the steepness of the intermediate part of the municipal yield curve by graphing the 2s-to-30s spread since 1994. As we can see, while the shape of the intermediate municipal yield curve has remained steeper than its long-term average of 137 basis points for over five years, the backup in yields between April and June, resulted in a **73 basis point steepening**. A steep yield curve offers investors the opportunity to lock in higher absolute yield levels

[read income] and along with those yields, long-term tax benefits by **extending maturities**. This most recent rise in interest rates offers investors the opportunity to pickup increased incremental term premiums with modest extensions in the intermediate part of the yield curve, making, in our opinion, intermediate maturities more attractive than short or long-term yields on a risk-adjusted basis.

Additionally, while the selloff during the quarter impacted all municipal bonds negatively, it did not affect all municipal bonds **evenly**. As a rule, **higher coupon bonds** outperformed lower coupon bonds. Due to the math of bond returns, for two bonds with the same maturity, the bond with the higher coupon will outperform the lower coupon bond during a period of rising rates due to its lower duration. Duration, you will recall, is a measure of the weighted average of the present value of all of a bond's cash flows. For example, a zero coupon bond with a 5-year maturity has a 5-year duration as well, because the only cash flow involved — the payment received when the bond matures — will be received in five years. By way of contrast, a 5-year bond that pays interest semi-annually will have a duration that's less than its 5-year maturity. If sold at par, a 5-year Treasury bond with a 1.5% coupon rate will have a duration of **4.85 years**. The reason the duration is less than 5 years is that some of the cash flows (specifically, the coupon payments) will be received prior to the bond's 5-year maturity. However, a 5-year Treasury bond with a 5% coupon priced to yield 1.5 percent, will have a duration of only **4.53 years**, a **7 percent** reduction in duration for otherwise identical bonds with the same maturity date. As a rule, the larger the bonds coupon, the shorter the duration, as a greater proportion of the total cash flows will be received prior to maturity. Over the past several years, as interest rates declined to historically low nominal levels, we have consistently emphasized high coupon premium bonds in client portfolios as a **defensive measure** in anticipation of a probable rise in interest rates. As such, those premium bonds, while negatively impacted by the rise in yields, were less negatively impacted than par or discount bonds. In addition, the premium paid on high coupon bonds results in larger periodic cash flows due to the return of a portion of that premium with each coupon payment, effectively bringing forward the payment stream and allowing reinvestment of those monies in a rising rate environment.



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Finally, despite the improving financial profile of many municipal bond issuers, recent news regarding the bankruptcy in Detroit and the downgrade of Illinois has cast a shadow over the market. Moody's downgraded the State of Illinois' \$27 billion of outstanding general obligation bonds to A3 from A2 and maintained the state's negative outlook after the Illinois General Assembly concluded its session on May 31st without addressing the severe pension liabilities that are the state's greatest credit challenge. Illinois has a pension plan that is currently only 40 percent funded. Without significant reforms, substantial growth in both unfunded liabilities and in the annual funding burden are likely in coming years. This trend may coincide with the expiration of most of the income tax increases the state imposed in fiscal 2011 to help cover pension costs. As a consequence, its payment backlog will likely remain large, despite some recent signs of improvement. Meanwhile in Detroit, the motor city finally succumbed to the sclerosis of a declining population and burgeoning legacy costs when on July 23rd, Detroit became the biggest-ever municipal bankruptcy filing, declaring more than \$18 billion in debt and 100,000 creditors, including retired city employees and municipal bond investors. Of key importance, was the unprecedented step by the city's emergency manager Kevyn Orr, of classifying more than \$530 million in general obligation debt as an **unsecured creditor** along with city pensioners, even though the GO debt is backed by the city's full taxing power. Under the proposed plan, they would receive less than 20 cents on the dollar. To date, no municipality has used bankruptcy to force GO bondholders to take a haircut on principal. Secured creditors, which includes bond investors backed by dedicated revenue streams, fared slightly better. They have been offered a settlement at par, but with reduced coupon payments and possible maturity extensions. Another key issue in the Detroit bankruptcy case will be whether or not state legislation that protects pensions will be superseded by the federal bankruptcy code. We will be watching as this issue unfolds as its outcome could have important ramifications for pension obligations and retirees.

While the size of the filing was unprecedented, Detroit's bankruptcy filing came as no real surprise. The actual event was the culmination of a process a long time in the making. According to Orr's report, the city's population had declined over 60 percent from its high in the 1950s and over 25 percent since 2000. Unemployment, which peaked at nearly 25 percent in 2010, remains in the high double-digits. There are over 75,000 abandoned structures and the city's violent crime rate is the highest of any large US city. Of the \$18.3 billion in debt declared in the bankruptcy filing, nearly \$10 billion relates to pension and legacy costs. And while the status of GO bondholders is likely to be challenged in the Detroit bankruptcy filing, we believe that the situation with Detroit is unique and is in no way representative of an underlying systemic problem within the municipal market. Now as always, the key to navigating the unique risks presented by the municipal bond market, lies in a proper assessment of credit risk based on a comprehensive understanding of the nuances of both the market and the securities. Unfortunately, this is something that can only be developed from time and experiences in the municipal market.

Fig 7

AA General Market Yields

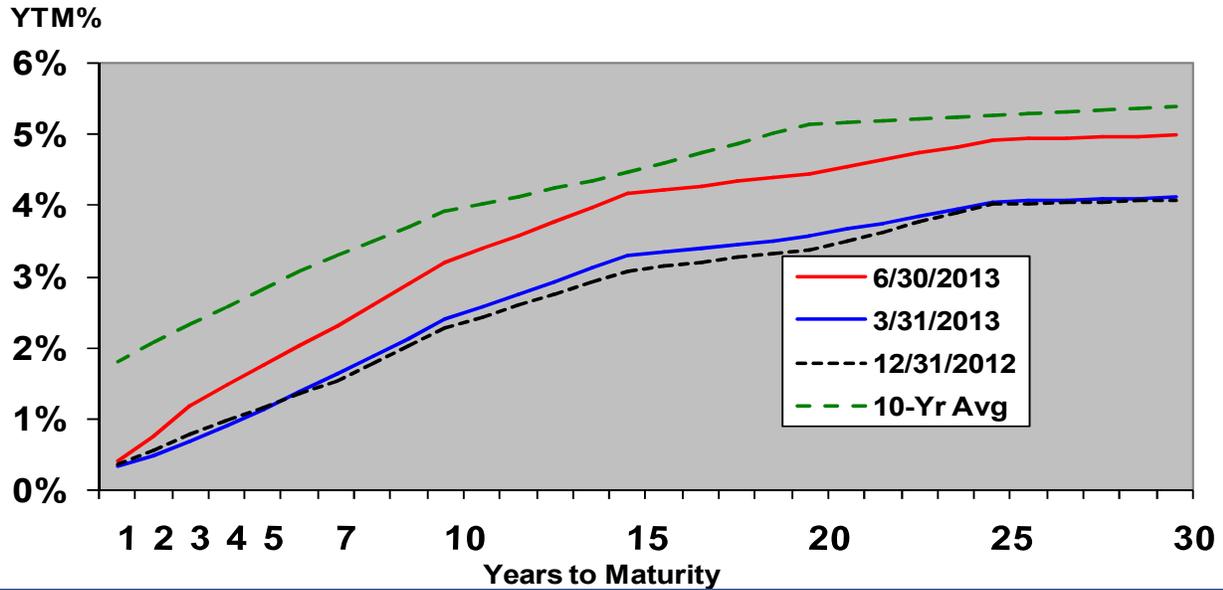
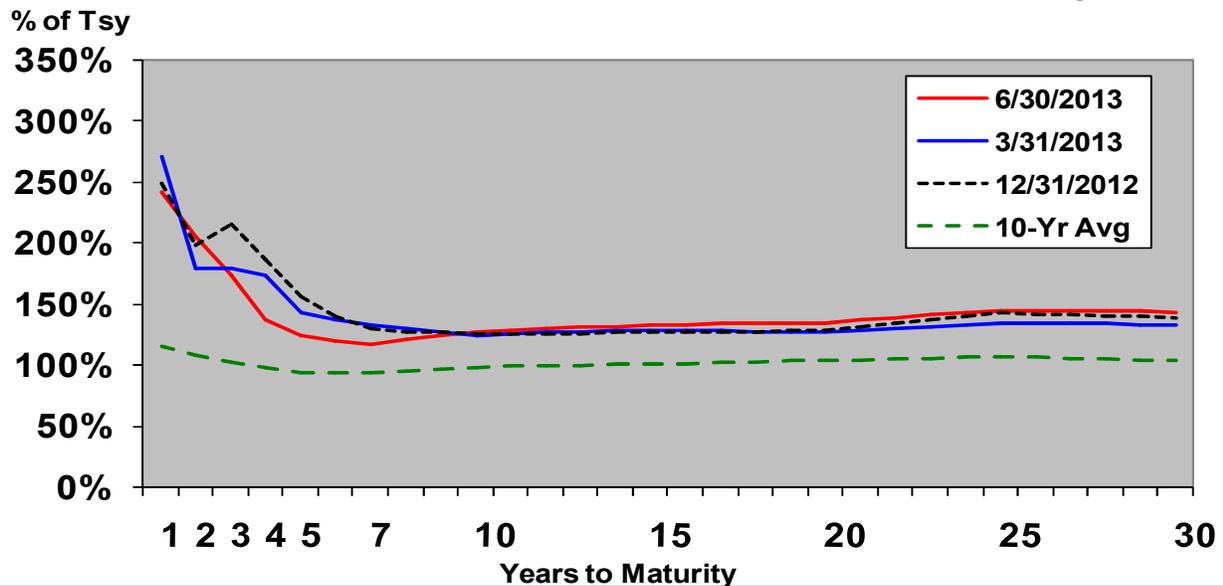


Fig 8

AA General Market Yields as % of Treasury



	10 Yr Avg	3/31/2013	6/30/2013
2-Year AA Municipal	107%	179%	206%
5-Year AA Municipal	93%	143%	124%
10-Year AA Municipal	97%	124%	126%
25-Year AA Municipal	106%	134%	144%