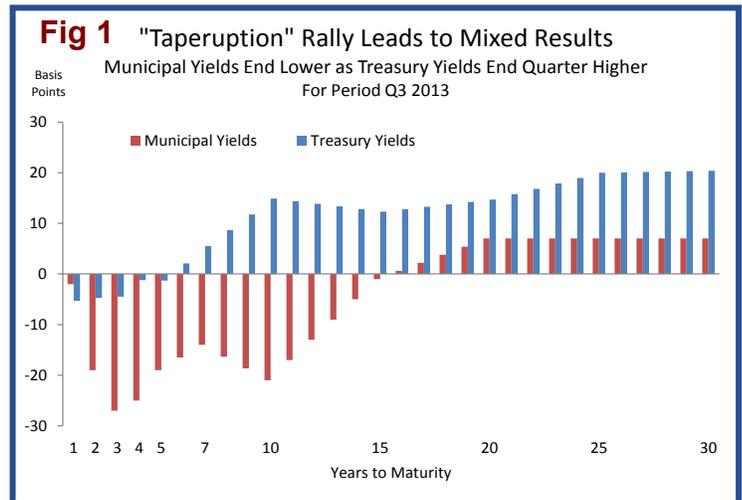




## Municipal Market Review

Third Quarter 2013

The sharp rise in municipal yields during the second quarter reversed course and gave way to a decline in yields during the third quarter as the primary cause of the rise in yields, the "taper tantrum", gave way to a "taperuption". In a September surprise announcement, the Federal Reserve voted not to reduce their Large-Scale Asset Purchase program, commonly referred to as quantitative easing, from its' current level of \$85 billion per month. After rising modestly through August, the September announcement by the Fed initiated a sharp rally as investors, recognizing the value created by rising municipal yields during the selloff, returned to the municipal market. In addition, the growing discord in Washington and the looming debt ceiling showdown also helped to drive investors back to the safety of high quality municipal bonds. For the entire third quarter, municipal yields rallied across most of the yield curve. The exception was in long-term maturities as yields on maturities greater than 15-years ended the quarter slightly higher. These changes in yields can be seen in **Figure 4** where we can also observe that overall, yields on municipal bonds remain in a "channel" -- above year-ending 2012 levels but below trailing 10-year historical levels. Also we can see that relative to this channel, the current municipal yield curve is markedly **steeper** than either of the comparison periods. Taken together, both observations confirm our contention that the back-up in yields due to the "taper tantrum" sell-off has acted to **restore value** in a market that had become overbought, particularly in the intermediate and long-term maturity sectors. **Figure 1** highlights the specific changes in both municipal and Treasury bond yields for the quarter. Importantly, while both municipal and Treasury bond yields rallied in the month of September in response to the "no-taper" decision, the rally fell short of fully off-setting all of the back-up in yield which occurred during the second quarter. For municipals, the rally was more broad-based with the cross-over point between falling and rising yields occurring around the 15-year maturity area, while for Treasury's, it was around the 7-year maturity area reflecting the gravitational pull of the Fed's zero interest rate policy. As a result of the changes in yields, the municipal yield curve ended the quarter modestly steeper with all of the steepening (28 basis points) occurring in the 10s-to-30s segment of the curve, reflecting the impact of the inflection point between declining and rising yields. Referring to **Figure 5**, we can see that with the exception of the very short maturities, **relative value ratios** declined slightly from second quarter levels as the rally in municipal yields outpaced the rally in Treasury yields. Overall, municipal bonds remain attractive, with relative value ratios above 100 percent and above their 10-year average for all maturities. When combined with a steeper yield curve, municipals currently offer investors better term premiums for maturity extensions.

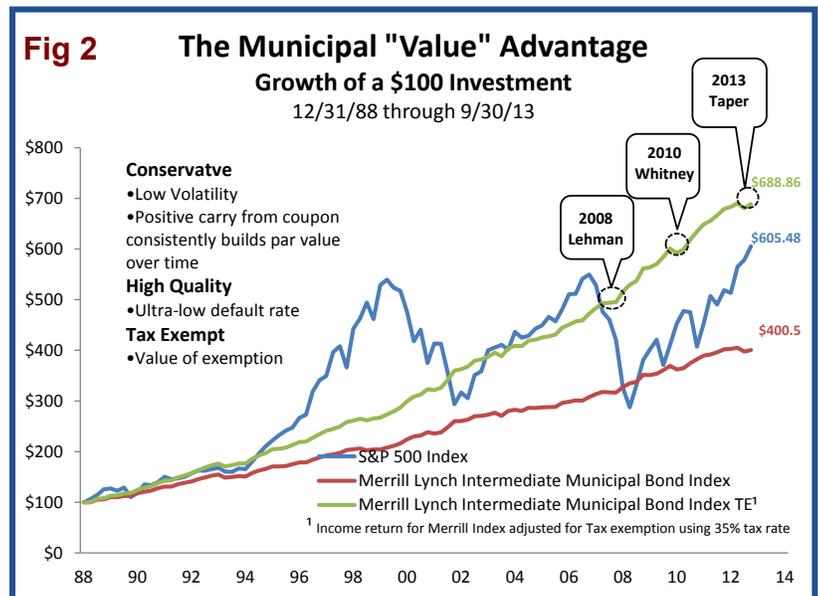


# Municipal Market Review

Third Quarter 2013

As we discussed last quarter, the late-summer sell-off acted to **restore value** in an overbought market, effectively opening a **window of opportunity** in which to deploy capital at **higher entry yields** for those who are positioned to do so. Quoting from the man who wrote the book ('Security Analysis' and 'The Intelligent Investor') on value investing; "*An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.*" In this simple yet elegant definition of an investment as opposed to speculation, Benjamin Graham establishes two essential criteria; 1) safety of principal, and 2) an adequate return. We have long held that the cornerstone of wealth management should be **capital preservation**, not capital appreciation. As such, the key criteria of our philosophy of portfolio management, grounded on the principle of capital preservation, is ensuring the "**safety of principal**" for our clients. And it is upon this cornerstone that we implement strategies to "**build par value**" through the attainment of an "**adequate return.**" We believe that due to certain inherent characteristics unique to municipal bonds, that municipal bonds are best suited to meet Graham's criteria of an "investment operation" dedicated to the preservation of client wealth.

**Figure 2** is an update of a chart we presented in early 2012. It illustrates the growth of \$100 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** as well as a **tax-equivalent basis**. This is done by parsing the income return from the price return and then adjusting the income return for the effect of the **tax-exemption** on municipal bonds. (A 35-percent tax rate is assumed) The investment begins on December 31, 1988 and continues through September 30, 2013. As we stated previously, *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 those characteristics of municipal bonds which makes them uniquely suited as an "investment operation."



In our opinion, municipal bonds represent the conservative approach to qualified investment operations for buy-and-hold investors. Several specific attributes inherent to municipal bonds which contribute to the safety of principal are **positive carry, predictable cash flows** and **lower volatility**. Each of these attributes contributes to the goal of "**building par value**", which across time, is the primary goal of portfolio management. Referring to **Figure 2**, we can see that contrary to the return pattern for stocks, the **return pattern** of an investment in intermediate municipal bonds tends to **rise consistently** over time. What is notably absent are the **sharp swings** in periodic returns and portfolio value, which

accompany an investment in stocks. The violent "**dips**" are replaced by modest "**blips**" in the chart. Consider the almost imperceptible declines for three of the most recent sell-offs in the bond market; the Lehman crisis of 2008, the "Whitney Effect" of 2010 and most recently the "Taper Tantrum" of 2013. In each instance, the decline in market value was minimal, and most importantly they did not alter the long-term rising return trend. This is primarily attributable to the fact that a substantial portion of a bond's return is "**guaranteed**" in the form of an income component (coupon), rather than from a change in price due to a change in underlying market conditions. Hence the institutional name for bonds, "**fixed income**". For buy-and-hold investors, over long-term holding periods, this guaranteed return component effectively eliminates market timing risk. By this we mean that the **rising return pattern** for bonds is unaffected by the point of entry. (Note: we are not suggesting that the terminal value is unaffected by the point of entry, only the persistent trend toward appreciation) Not only is the coupon contractually guaranteed, but it is also paid on regular and predictable intervals, providing the investment with "**positive carry**", a characteristic we develop more fully below. Additionally, by focusing on intermediate maturities, **price volatility** due to changes in market interest rates (the "blips") 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 preserving wealth.

While perhaps mildly technical, the importance of "**positive carry**", an attribute unique to bonds, is often overlooked. The importance of this attribute was recently examined in a research report published by Morgan Stanley entitled 'Duration Targeting and Index Convergence'. In this report, the authors concluded;

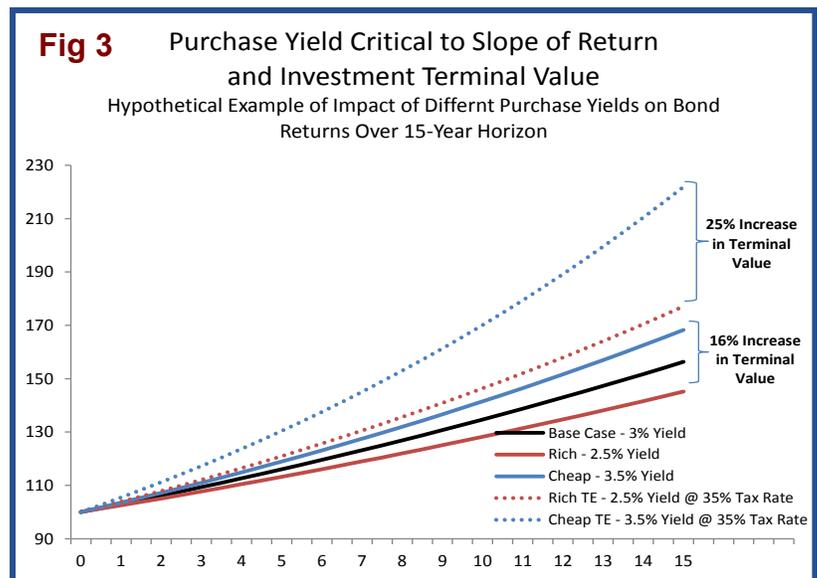
*"Most institutional -- and individual -- investors follow a rebalancing process that maintains a relatively stable duration over time. This Duration Targeting can lead to multi-year return patterns that are quite counter-intuitive. Over shorter horizons, the price effects can overwhelm the yield accruals. However, over longer horizons the accumulating yield accruals will tend to offset these price effects. The net result is that, **over a sufficient investment horizon, the annualized return is driven back towards the starting yield -- regardless of whether rates are rising or falling.**"*

Setting aside issues related to the researchers implicit assumption about "costless rebalancing", there are two important takeaways we want to emphasize. First, over long investment horizons (they defined long as "6-to-10 years"), the **yield accrual**, or "**positive carry**", tends to offset or overwhelm changes in price, or volatility. Looking again at **Figure 2**, that is precisely the reason that the return trend for bonds is persistently upward sloping. The longer the bond(s) are in place, the **cumulative yield accruals** will come to dominate the price effects, driving the total return towards the starting yield in what the authors term a "**convergence-to-yield effect.**" Clearly this has important implications for investors who wish to emphasize capital preservation as their primary investment goal as it strongly suggests that under conditions of active rebalancing (or active management), the starting or **purchase yield** is the primary determinate of horizon return, **not changes in interest rates**. According to the authors, this "convergence-to-yield" effect was found to hold true *"even in the face of sharply rising or falling rates throughout the investment period."* Clearly then, the key to "**adequate returns**" for buy-and-hold municipal bond investors committed to safety of principal, is the attainment of "**value**" by locking in the highest purchase yields attainable.

# Municipal Market Review

Third Quarter 2013

That brings us to the second takeaway, the role played by "purchase yields" in the determination of "adequate" horizon returns. **Figure 3** is a hypothetical example, very much like the growth chart in Figure 2, which illustrates the impact of different starting or purchase yields on bond terminal values over a 15-year investment horizon. While simple in its calculation, it visually drives home the importance of the starting yield on portfolio returns. Since owing to the **convergence-to-yield effect**, the income accrual on a bond comes to dominate price changes in determining horizon returns, clearly the primary determinate of an adequate return for buy-and-hold investors will be their ability to **lock-in the highest purchase yield possible**. **Figure 3** illustrates two aspects of this fact. First, owing to the value of compounding, the **slope** or **steepness** of the return line is determined by the height of the original purchase yield. Second, the **slope drives the terminal value** for a given investment horizon. In our example, the base case represents a stylized "fair value" purchase yield of 3% compounded semi-annually across the 15-year investment horizon. The bond labeled "rich" assumes the investor paid **50 bps above fair value**, and therefore compounds at the lower purchase yield of 2.5% over the life of the investment. The bond labeled "cheap" assumes the investor purchased the bond **50 bps beneath fair value**, and therefore it compounds at a higher purchase yield of 3.5%. Clearly the "cheap" bond has a steeper slope (meaning it has a higher value at any point along the investment horizon) and a higher terminal value. In fact, the terminal value of the cheaper bond is **16% greater** than that of the rich bond in this illustration. While that represents a significant return difference over the life of the investment, the difference between the two bonds is greatly magnified when we adjust them for the tax-exemption unique to municipal bonds. When we do this, the increase in terminal value rises to a very "adequate" **25%**.



Obviously this analysis is predicated on a no-default assumption and that brings us to the topic of "risk". As we have stated on multiple occasions, properly defined, **investment risk is the risk of loss** -- period! As such, risk is never a number (volatility). The municipal bond market is a unique and diverse market comprised of over 2 million dissimilar bond issues of all shapes and sizes, issued by over 90,000 different issuers with roughly \$3.7 trillion in debt outstanding, with each bond carrying its own unique risk profile. In this environment, generalizations are both difficult and hazardous. As such, the proper evaluation of risk in the municipal bond market requires both experience and attention to detail. This demands familiarity, both with the nuances of the market as well as with the issuers, along with sound credit research. Since the collapse of the mono-line insurers, risk evaluation in this new era of **credit discovery** has become even more important, as the investor tradition of simply relying on quality ratings back-stopped by third-party bond insurance has proven to be unsound.

## Municipal Market Review

Third Quarter 2013

As we have oft repeated to both existing as well as potential clients, **"every good bond goes to par."** While seemingly overly simplistic, this truism contains a key insight to bond management, and by extension, investment allocation. Unlike stocks, barring an outright default, bonds are contractually obligated to pay interest **and return an investor's principal at maturity**. Absent a default then, over the course of the life of the bond investment, the "par value" of the client portfolio will be perpetually rising due to the power of "positive carry", and the rate at which a client's par value rises will be determined by his purchase yield. Under these conditions and for the reasons described in this review, that investment operation will provide "safety of principal" and an "adequate return" to the investor. And as we have tried to suggest, bonds, and in particular, municipal bonds, are uniquely suited for this role. Central to the success of this goal is the employment of strategies designed to **build par value** by maximizing tax-adjusted purchase yields while avoiding credit events. This is a role that we believe we are "uniquely" qualified to fill.

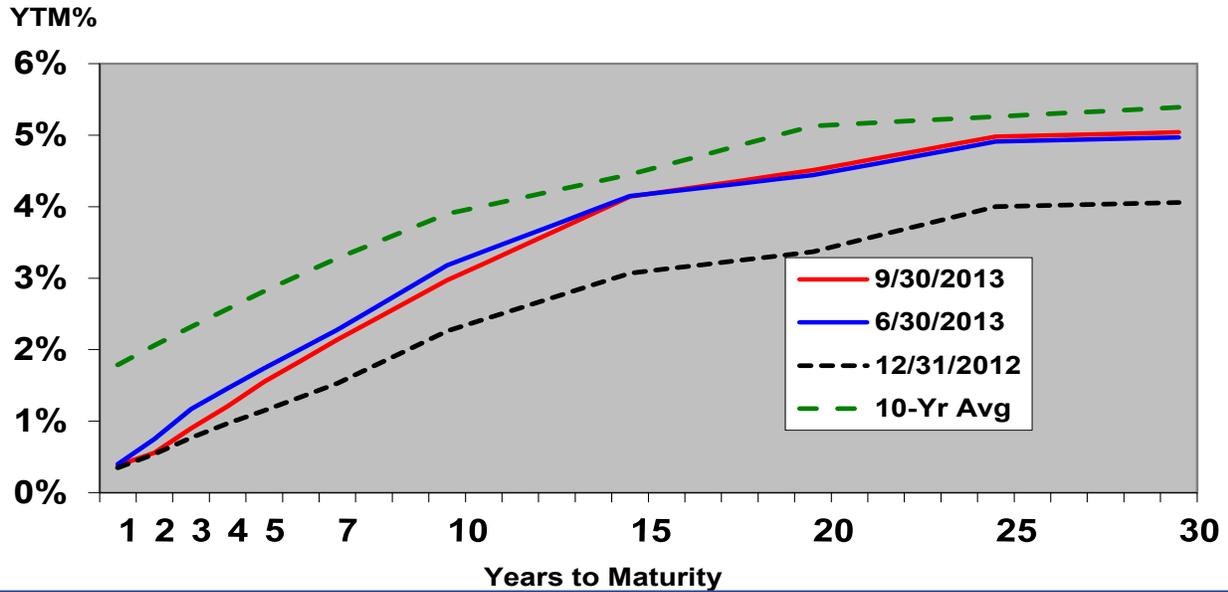
Drawing again from the wisdom of Benjamin Graham; *"The essence of investment management is the management of risks not the management of returns."* This reminds us that the **"race is not always to the swift"**, rather, what is important is not how fast you get to your goal, but how much you get to keep.

# Municipal Market Review

Third Quarter 2013

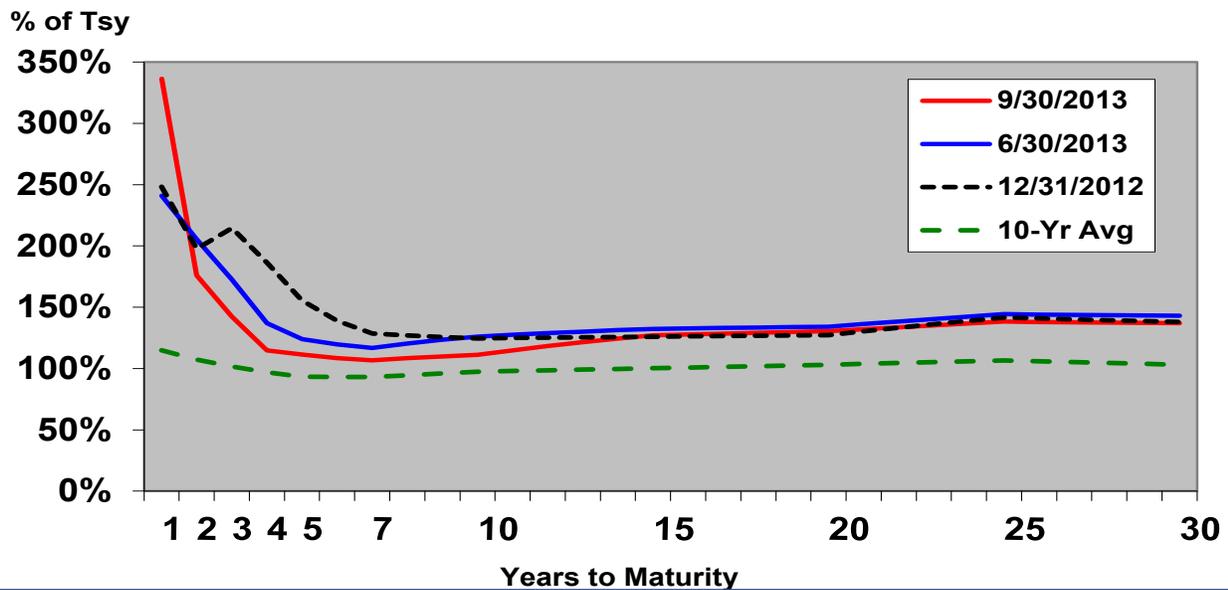
**Fig 4**

## AA General Market Yields



**Fig 5**

## AA General Market Yields as % of Treasury



	10 Yr Avg	6/30/2013	9/30/2013
2-Year AA Municipal	107%	206%	176%
5-Year AA Municipal	93%	124%	111%
10-Year AA Municipal	97%	126%	111%
25-Year AA Municipal	106%	144%	