

Thought for the Week: Monday, April 26th, 2010

What Next for Municipal Bonds?

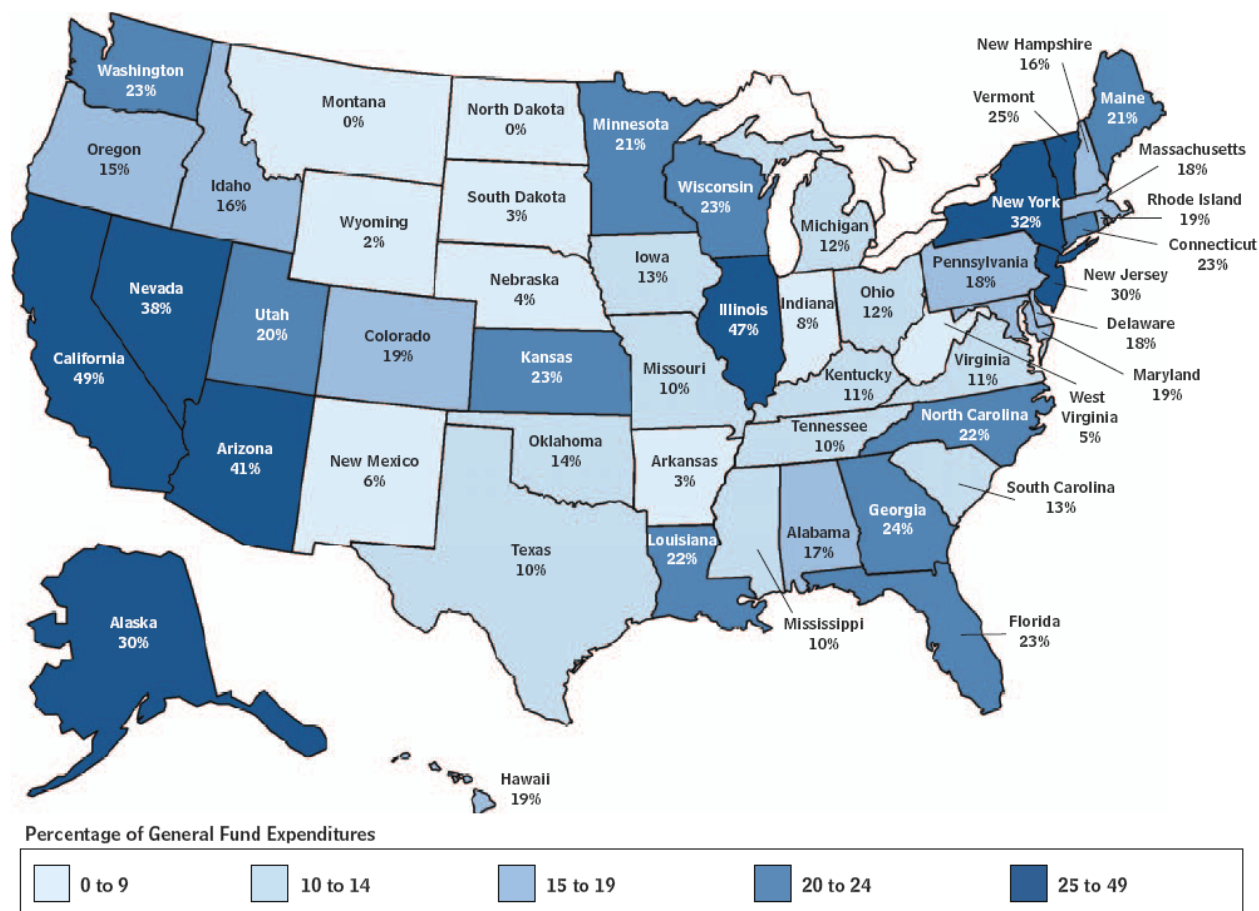
The Case For Municipal Bonds (Munis)

Many conservative investors favor a large allocation to Municipal Bonds. **Munis pay attractive tax-advantaged income with low historical risk of default:**

- **General Obligation (G.O.) Munis** are backed by the ability of a municipality to collect taxes. Those who support the old adage “there are two certainties in life: Death & Taxes” feel G.O. Munis are quite safe. In last 40 years, only three G.O. Bonds have defaulted.
- **Revenue Munis**, secured on the ability of a specified project to generate revenue, have been viewed with a higher degree of default risk, as any specific project can fail to hit its targets.

Although **there’s much talk of rising municipality budget deficits**, it’s hard to see the kind of defaults among states and cities that you’ll see for corporations.

State Budget Gaps, Fiscal Year 2010



Past performance is not indicative of future results. This commentary is not intended as investment advice or an investment recommendation it is solely the opinion of our investment managers at the time of writing. Nothing in this commentary should be construed as a solicitation to buy or sell securities.

Taxation¹

Here's an easy prediction "Taxes Will Rise in 2011". If the IRS increases their share of investment gains, net returns to investors will reduce. Therefore, the higher the tax bracket you are in, the less you'll make from your investments.

This will make tax-advantaged investments, such as Munis, more attractive. Increased demand for Municipal Bonds should exert upwards pressure on their price.

Income

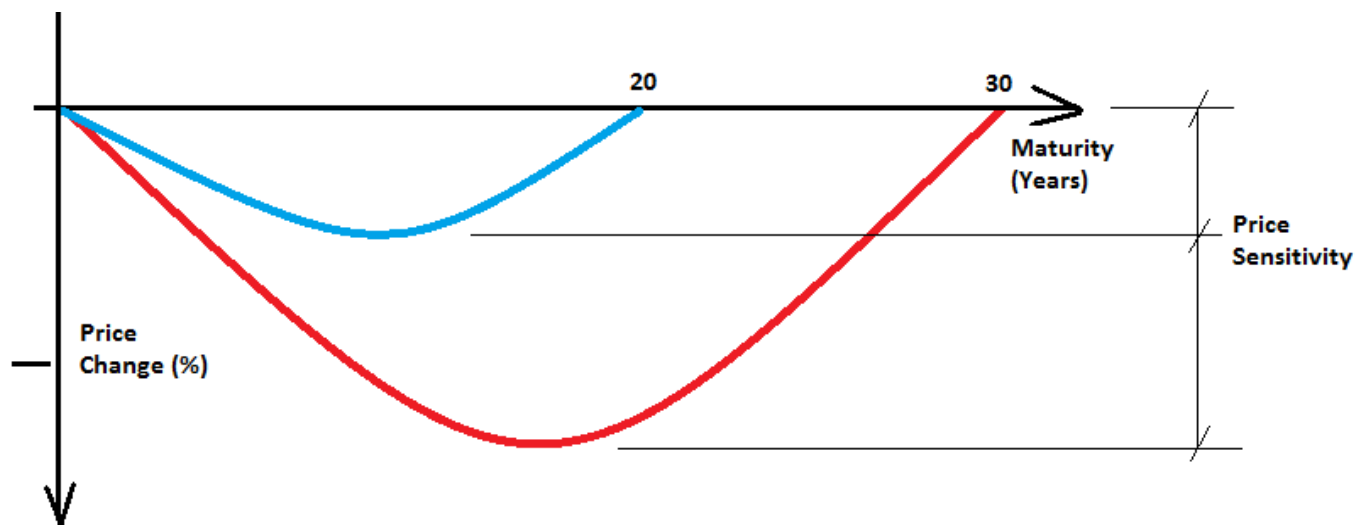
Many Munis pay in region of 5% tax-exempt. This is a **healthy level of income for a medium- or high-level tax payer**, providing the issuing municipality possesses a low risk of default. It is difficult to advise a client to sell a low volatility investment paying this level of income, unless they are fearful of losing capital if and when prices fall.

The Case Against Munis

Interest Rates

Munis are often issued with **longer maturity than corporate debt**; it is not unusual to see them with a maturity of 20 years or more. History, and most text books, tells us that the longer the bond maturity, the more sensitive the price to interest rate movements.

The chart below shows a hypothetical example of the expected movement of a 20 Year Bond (Blue line) and a 30 Year Bond (Red line) as interest rates rise. Both bonds are subject to the same change in interest rates but the price of the longer maturity drops by a great amount than the shorter maturity bond. In general, **the closer you get to maturity, the closer the price of a bond goes to par**.



Bottom line:

The longer to maturity, the more likely an investor will suffer a loss as interest rates rise.

¹ This commentary is not intended to offer specific tax advice. Investors should consult a qualified tax advisor prior to making any specific tax related investment decisions.

Credit Risk Perceptions

Bond prices change when Credit Risk Perceptions change. E.g. If investors think a bond has a higher chance of failure, its price will fall and the yield will rise.

Our current view of Muni credit risk is: Investors have become increasingly comfortable with Muni default risks despite the deep and endemic budget deficits diagrammed on page 1.

Although we have already stated our opinion that the risk of Muni default is fairly low, excepting the odd issue based on a flawed project, **the perception of increased risk could reduce Muni prices.** Long-term market prices are commonly based on fundamentals but bear in mind that investor perceptions have a significant effect in the short term.

With most finding it hard to balance their books, we find it hard to believe that municipalities will not hit the financial headlines for the wrong reasons at some stage in the next year or two. **This will bring their credit worthiness and their prices into question.**

What will happen to Munis across the board if the Ratings Agencies decide to downgrade a few municipalities? Will they all be able to make the difficult decisions necessary to address their financial problems?

The odds on a few defaults happening look pretty strong – then what happens to the perception of ‘low credit risk’?

Are Munis Overbought?

Since the start of the year, investors have poured approximately than \$15 billion into Muni-bond funds and exchange-traded funds—nearly twice the amount they have put into all domestic equity funds and ETFs, according to Lipper FMI.

Demand as strong as this can create unrealistic price levels, especially when it contradicts fundamentals such as the potential for interest rate driven price falls.

DIAS & Munis

We currently have little or no exposure to Munis in our Core portfolios. The potential for credit risk surprises, particularly in light of the current European and Domestic malaise, makes us wary.

Our expectation is that the **budgetary issues raised above will have an impact in the next year or so** making Munis much cheaper. At that point, we may invest.

“If the American people only understood the rank injustice of our money and banking system - there would be a revolution before morning...”

Nicholas Biddle (President of the Second Bank of the United States) in 1836