



## ADVANTAGES OF TAXABLE MUNICIPALS VS. CORPORATES

July 2010

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*Recent spread widening in taxable municipal bonds provides a unique opportunity for investment in a high quality asset class, particularly in separate accounts. When compared with corporate bonds, it is an even more compelling investment.*

Reasons for recent spread widening in taxable municipals:

- » Headlines highlighting fiscal stress in municipalities.
- » Uncertainty over extension of BABs program.
- » Sharp decline in Treasury yields.
- » New issuance concentration in just a few states; mostly those with severe budgetary problems.

The taxable municipal sector as a whole has widened, yet investors are distinguishing between higher quality and lower quality bonds with lower quality bonds widening more. This "throw the baby out with the bathwater" phenomenon provides an opportunity to invest in higher quality taxable municipal bonds at significantly higher yields than comparably-rated corporate bonds.

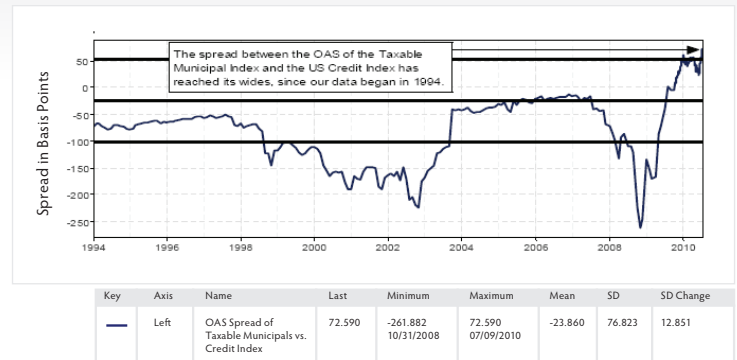
Reasons for recent corporate bond spread tightening:

- » Investor demand for yield.
- » Overall corporate balance sheet strength, improved fundamentals.
- » Coming out of a long period of low event risk.

The corporate bond sector has experienced significant spread tightening reflecting strong demand for yield. Current spread levels are historically narrow, and while they could narrow further over the near term, it is likely spreads will widen due to a resurgence of "equity holder friendly" events. For example, dividend increases, and one time shareholder payments are increasing, and large cash positions could be used for mergers and acquisitions. Increased government regulation could also impose additional costs on certain corporations. At the current narrow spread levels, the risk/reward for future outperformance is leaning towards more risk.

FIGURE 1: OAS SPREAD - TAXABLE MUNICIPAL VS. CREDIT INDEX

Source: Barclays Capital



*Barclays has been tracking taxable municipals since 1994, and the spread differential between taxable municipals and corporate bonds has never been wider. In our view, this is an unprecedented opportunity to purchase taxable municipal bonds.*

### THE CASE FOR SEPARATE ACCOUNT MANAGEMENT WITH TAXABLE MUNICIPAL ALLOCATIONS

With the introduction of the BABs program, taxable municipal issuance has dramatically increased. According to the Bond Buyer, Year to Date issuance has increased +152% over 2009 issuance. Investor participation has followed, and several Index Funds and ETF's have been created as a result of this increased interest. It is important to note however, that taxable municipal index funds are dominated by just a few large issuers. Within the Barclays taxable municipal index, the top five issuers are:

- » California (29.39%) (A1/A-/BBB)
- » Illinois (17.87%) (A1,A+,A-)
- » New York (10.36%) (Aa2,AA,AA)
- » New Jersey (7.55%) (Aa2,AA,AA-)
- » Texas (6.69%) (Aaa,AA+,AAA)

These five states comprise approximately 72% of the index. Clearly, an index fund would not only offer very little diversification, but would instead provide a heavy concentration in four states that are currently severely fiscally stressed, (California, Illinois, New York and New Jersey).

Additionally, most of the larger "index eligible" issues have maturities greater than 10 years resulting in a fund with a longer maturity and duration.

Separate account management provides broader diversification in terms of overall quality, maturity and geography.

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