

# Building a Fixed-Income Portfolio with Taxable Municipal Bonds

*A Discussion Paper from Breckinridge Capital Advisors*

We believe there is a compelling case for creating a stand-alone allocation to U.S. taxable municipal bonds as a way of generating attractive risk-adjusted returns in a high quality, fixed-income portfolio. Taxable municipal bonds represent an investment with all the characteristics that appeal to the fixed-income investor: safe, reliable income and predictable returns. Taxable municipal bonds and Build America Bonds (BABs), in particular, tend to offer high quality credit profiles, potentially higher yields than similarly rated corporate bonds and a sizable opportunity for diversification. The launch of BABs in April 2009 stabilized the municipal bond market, broadening the investor base and significantly expanding overall market capitalization. In our view, the BAB program will almost certainly be made permanent in 2010, which will further expand investment opportunities in the taxable municipal market.

## Reasons to Make a Stand-Alone Allocation in Taxable Municipals

- **Taxable municipal issuers tend to have a very high quality credit profile** compared to issuers of non-government debt. Municipal bond default rates are significantly lower than corporate bonds due primarily to the monopolistic nature of municipalities and strong legal protection provided to bondholders. Yet U.S. municipal bonds are under-rated relative to corporate bonds, creating opportunities for investors.
- **Taxable municipals offer potentially higher yields** than similarly rated corporate bonds. The yield advantage has improved as corporate spreads have narrowed. We believe municipal yields will close that gap as investors recognize a buying opportunity and take advantage of it.
- **With a broad range of issuers, meaningful diversification is possible** with taxable municipals. Since BABs launched in April, more than 935 different issues have come to market. This is a key differentiator from other fixed-income sectors.
- **Taxable municipals finance projects with valid public purposes.** Schools, bridges, hospitals and other projects that support the long-term economic growth of our communities are excellent investment targets for pension funds, foundations and endowments.

In our view, a stand-alone allocation to taxable municipals is highly desirable. Low risk and attractive returns are core objectives for most fixed income investors. That fact alone makes a compelling case for a taxable municipal portfolio as the foundation for any fixed income allocation – not simply a tactical weighting within a much broader strategy. Given the unique characteristics of the taxable municipal market, executing a stand-alone allocation with a high quality portfolio requires a distinctive set of skills, including specialized credit research capabilities and a broad dealer network. Municipal bond specialists are best equipped to help investors realize the advantages of a taxable municipal portfolio.

## **Background**

The 1986 Federal Tax Reform established strict rules on qualifications for tax-exempt municipal bond issuance. If a bond issue is ineligible for tax-exemption, then municipalities issue taxable municipal bonds. Through 2008, aggregate taxable municipal bond issuance totaled approximately \$380 billion or 5.3 percent of total municipal issues. In our view the small size of the taxable municipal market limited the number of investment opportunities and hampered secondary market liquidity.

With the creation of the BAB program as part of the American Recovery and Reinvestment Act of 2009, the taxable municipal bond market has expanded significantly and is poised to grow much further. BABs allow state and local governments to issue taxable bonds and receive a subsidy from the U.S. Treasury in the form of regular payments equal to 35 percent of the interest on the bonds for the life of the debt. Under current legislation BABs must be issued by December 31, 2010.

The first BABs were issued in April 2009. According to Bloomberg, through February 2010, BAB sales totaled \$79 billion across more than 3,000 different securities. The Obama Administration proposed in its fiscal 2011 budget to make the BAB program permanent. The proposal would greatly expand the program to include other municipal issuers such as nonprofit hospitals and universities. It also proposes to cut the BAB subsidy to 28 percent in order to reduce the cost to the Treasury.

## **The Benefits to Borrowers**

In our view the BAB program has restored order to the municipal market by providing conventional, fixed-rate debt that better matches municipalities' long-term project financing requirements. It has been well documented how earlier attempts to work around the mismatch between supply and demand – by converting long-term tax-exempt bond supply to short-term floating-rate securities – ended disastrously in 2008 when those short-term structures collapsed. Many municipalities are still weighed down by expensive debt as a consequence.

BABs are stepping in where these costly efforts failed. In addition to improving the supply/demand ratio, these bonds have significantly reduced borrowing costs for the typical AA-rated municipality. This is especially the case in longer maturities where traditional tax-exempt demand is weaker as shown in Figure 1.

**Interest Rate Comparison**  
**AA General Obligation Bond Issue: 2/25/10**  
**Build America Bond (Net of 35% Subsidy) vs. Tax-Exempt (MMD)**

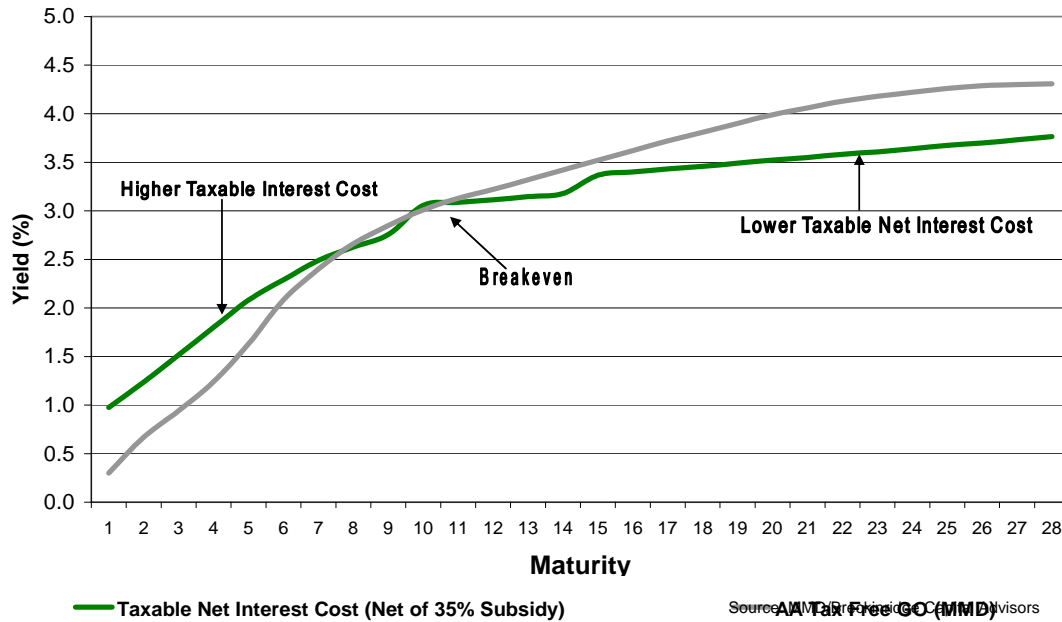


Figure 1

It is also worth noting that the arrival of BABs has reduced supply pressure in the tax-free municipal market. As a result, tax-free yields, especially on longer maturities, have fallen sharply from the peak levels of late 2008.

A further benefit of BABs is their appeal to several new investor classes, including pension plans, foreign institutions, taxable bond funds, Taft Hartley plans and 501(c) (3) plans, as well as endowments and foundations.

Some pension plans, both public and private, already have formal allocations to infrastructure investment and BABs used to finance infrastructure improvements can qualify for those allocations. Separately, we believe that more private plans will adopt liability-driven investing over the coming years in an attempt to better match plan assets with long-term liabilities. This move often implies increased exposure to the bond market in order to achieve a predictable income stream and we believe BABs are an ideal vehicle for this purpose.

As for foreign institutions, their appetite appears to be especially keen. A Federal Reserve report in December showed that foreign investors owned \$53 billion of municipal bonds at the end of third quarter 2009, an increase of more than 33 percent since the BAB program was launched.

**The Appeal for Investors**

The BABs issued to-date have offered higher yields than comparably rated corporate bonds. Figure 2 below compares two representative BABs with two similarly rated corporate issues.

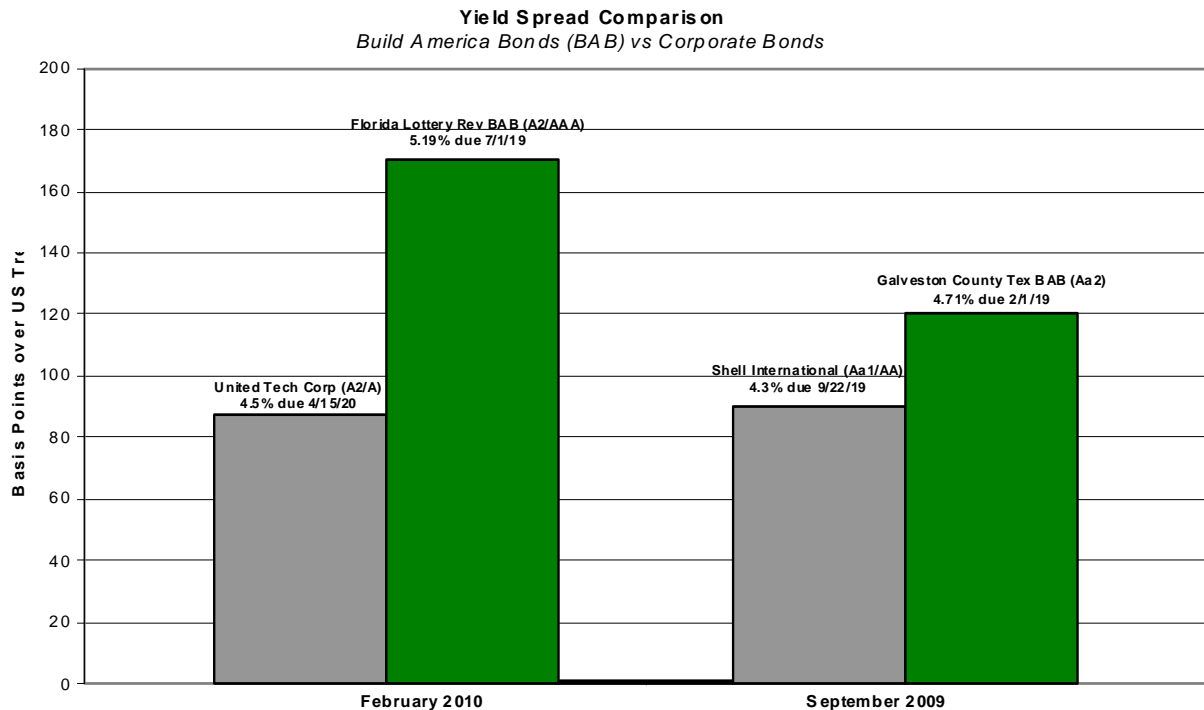


Figure 2

In addition, many BABs have qualities that make them inherently safer than non-governmental debt. These include:

- Restraints on state and local borrowing have kept overall municipal debt levels stable relative to GDP and below their peak in the 1980s. (Source: Federal Reserve Statistical Release, December 10, 2009)
- Municipalities place a very high priority on debt service, as they do not wish to jeopardize their access to the bond markets they depend on for project financing.
- Voter authorization is required for many types of municipal borrowing and may not be forthcoming if the consequence is higher taxes.
- Municipal bonds lack event risk and offer the transparency of municipal budget processes. Certainly there have been issues surrounding municipal disclosure but standards are clearly improving thanks to the growing application of technology.

The historical default rate on municipal bonds is extremely low, as illustrated in Figure 3. This is partly due to the monopolistic nature of municipalities. Municipalities control essential services and are perpetual, unlike corporations that may be acquired or dissolved. The municipal market also offers strong legal protections for bondholders, including debt restriction, balanced budget requirements and full faith and credit legally enforceable by courts.

**Moody's Average Cumulative 10 Year Default Rates  
Municipals versus Corporates  
(1970-2009)**

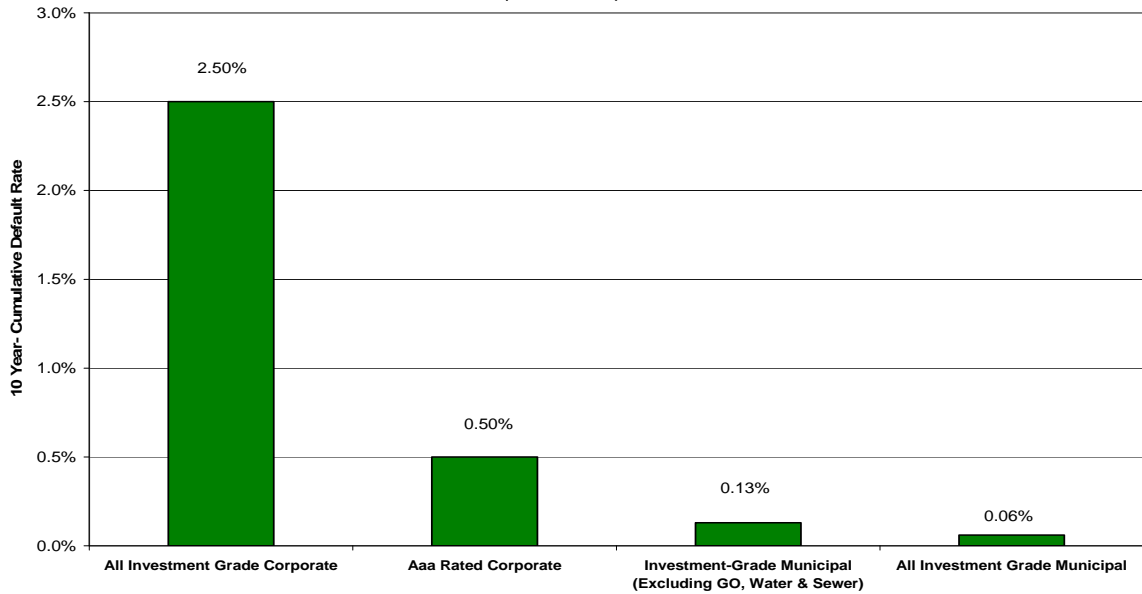


Figure 3

Despite excellent credit quality, U.S. municipal debt is typically rated much lower than corporate debt, when rated purely on the basis of expected loss. Yet municipal yields are often the same or even higher than yields on similarly rated corporate debt, as shown in Figure 4.

**TAXABLE CREDIT SPREADS**  
*SOURCES: MMD / Federal Reserve*

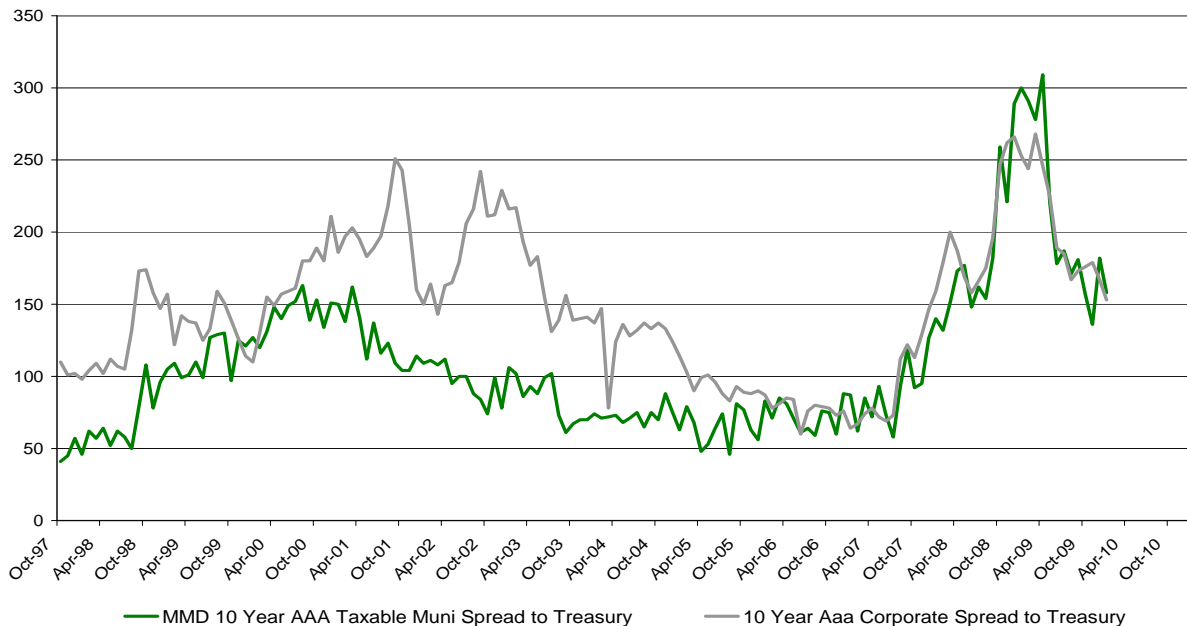


Figure 4

With a clear yield advantage, it is not surprising that institutional investor interest in taxable municipal bonds is on the rise. Although spreads on municipals to Treasuries have not narrowed as much as corporate spreads, we can expect further compression as institutional investors deepen their commitment to taxable municipals.

### **How to Execute a Stand-Alone Allocation**

We believe there is a compelling case for a dedicated allocation to taxable municipal bonds. We also believe that due to the fragmented nature of the municipal market, implementing a stand-alone allocation requires unique credit analysis and trading skills.

The municipal bond market has a broad and deep range of issuers. Since the biggest issuers in the municipal market are not necessarily the best credits or the best value, investors must gain access to a very large number of small and mid-sized borrowers. Many of these issuers have a very high quality credit profile and represent outstanding values. The breadth of credit research required to cover many thousands of issuers is substantial and quite different in its approach from corporate credit analysis.

In addition, there is no central exchange for municipal bonds and trading in the secondary municipal market is infrequent. Market activity is spread over more than 200 dealers. Maintaining a broad dealer network is critical to finding the right opportunities at the appropriate time.

Working with a municipal bond specialist is the optimal way to execute a stand-alone allocation in taxable municipals. A municipal bond specialist understands the value of fundamental credit analysis, opportunistic trading and, most importantly, the preservation of capital and can help investors realize the advantages of a taxable municipal allocation.

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