

Municipalities have been issuing taxable municipal bonds since 1986. In that year, Federal tax reform enacted strict Treasury guidelines on the qualifications for tax-exempt financing. If a bond issue's purpose is deemed ineligible, a municipality must issue taxable instead of tax-exempt bonds. Taxable bonds are often issued for private purposes; for example, two years ago Aspen, Colorado borrowed funds to rehabilitate a theatre complex. Due to the private use of the funds, this bond was ineligible for tax-exemption. Typically, the security of a municipality's taxable bonds is no different than that of its tax-exempt bond equivalent.

Breckinridge has invested in taxable municipal bonds since 1996 (with a taxable composite dating back to the start of 2005). The case for buying taxable municipals is quite straightforward. Taxable municipal bonds usually yield at least as much as similarly rated corporate bonds (chart 1), but have far less risk based on historic default rates (Chart 2). The only hesitation for some has been the relatively small size of the taxable municipal market. With only about \$190 billion outstanding (7% of overall municipal market), large investors worried about limited investment opportunities and illiquidity.

The taxable municipal market is now poised to grow substantially. As noted in previous newsletters, The American Recovery and Reinvestment Act of 2009 gives municipalities the option to issue taxable bonds and receive a 35% Federal subsidy on the coupon interest for the life of the bond. Under this particular program bond proceeds must be used for new capital expenditures (no refundings) that would otherwise qualify for tax-exempt financing. Currently, the program is scheduled to expire at the end of 2010, however we believe it's likely to be extended further – perhaps even made permanent. The taxable municipal bond program has two compelling advantages that will be hard for municipalities and the market to give up.

First, the new taxable municipal bond program offers municipalities a better interest subsidy, particularly in long-term bond maturities. The 35% cash Federal subsidy is guaranteed to the municipality for the life of the taxable bonds. In contrast, the permanence of the tax free "subsidy" for investors in tax-exempt bonds is less certain. The tax-preference for the investor may not last for the life of the issue. An investor's tax rate may decline or the current Federal tax-exemption could be altered. Because of these uncertainties, tax free investors are less willing to accept a yield that is fully 35% below that of a comparable taxable bond – especially in the distant future with long maturities. This means the taxable bond option provides a better subsidy (lower net yield) to the municipality (Chart 3).

Second, the taxable municipal bond program remedies an imbalance in the municipal market between supply and demand. Municipalities typically finance capital projects with long-term bonds; however, the dominant buyers of tax-exempt debt are high net worth investors with short and intermediate investment horizons. Until recently, this mismatch was resolved by converting long-term muni bonds to floating rate instruments (VRDNs and Auction Rate Notes) or using the Tender Option Bond structure to leverage long-term bonds. The new taxable municipal bond option will now move some of the supply of long-term bonds out of the tax-free market and into the taxable bond market where insurance companies, endowments and pension funds are major buyers. These institutions have a much greater appetite for longer duration bonds. They also prefer the high quality of most municipal issuers, especially now with the shrinking supply of high quality corporate bonds.

The new taxable municipal bond program has already received an enthusiastic reception attracting substantial interest from large institutions. Yet the opportunity represents more than just a trade or tactical position. Taxable municipal bonds have merit as a core weighting in a long-term fixed income strategy. If properly managed, a municipal bond portfolio generates a relatively attractive return while providing a safe, reliable source of income and capital. These usually represent the *primary* objectives of fixed income investors. Therefore, a taxable municipal portfolio should stand alone as a separate asset class within a high grade fixed income allocation.

In making a taxable municipal allocation, the case for using a municipal bond manager is just as compelling as with tax-exempts. It is critical to thoroughly understand the credit risk of every municipal bond, which requires a dedicated and experienced municipal research team. To structure a balanced and diversified portfolio, it is also essential to have broad access to the municipal market through a very wide network of dealers. Breckinridge combines these capabilities with an investment process that is well adapted to the unique characteristics of the municipal market. In recent years, our investment team has expanded to include additional expertise in corporate and agency markets. As a result, Breckinridge is extremely well positioned to manage high quality taxable fixed income portfolios and take advantage of the growing opportunity in taxable municipal bonds.

Chart 1

Taxable Yields - Corporates and Municipals
Source: MMD/Federal Reserve

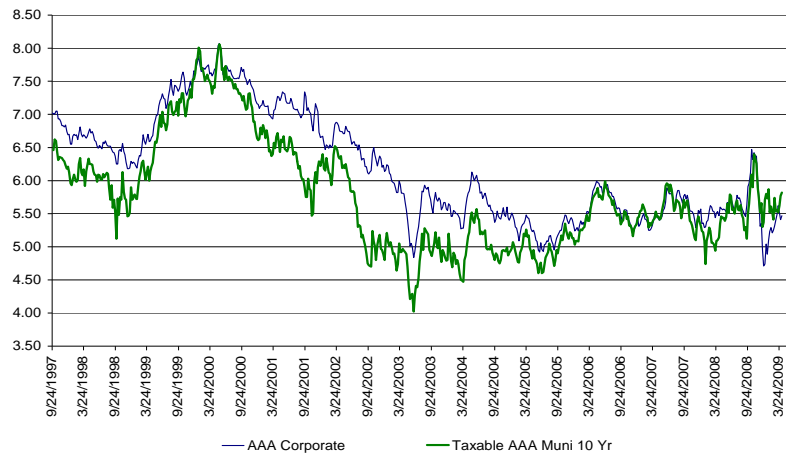
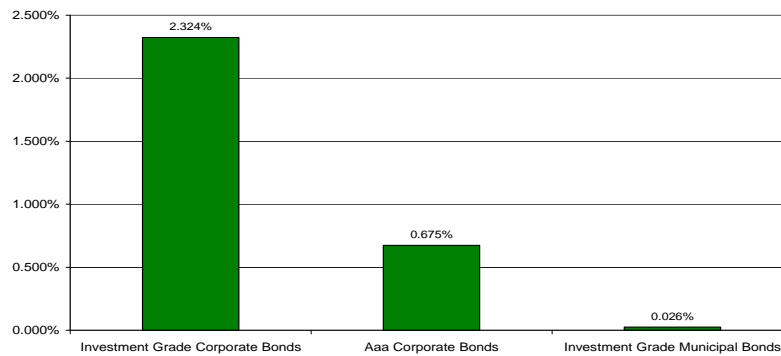


Chart 2

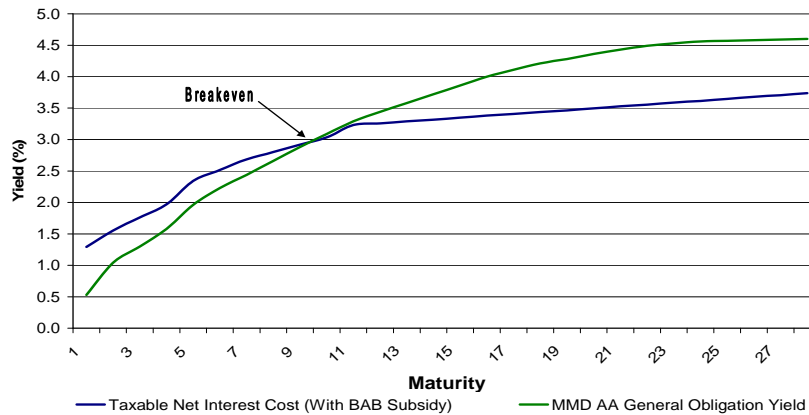
Comparative 10-Year Default Rates
Source: Moody's*



*10 - year cumulative default rates for all Moody's investment-grade rated municipal bond issuers and investment-grade rated corporate bonds for the period 1970 - 2000

Chart 3

Yield Curve Comparison as of April 27, 2009
Net Taxable B.A.B Yield* vs. MMD - AA G.O.
Source: MMD



*BAB Spread off Treasury Curve:
150 bp 1-5 Years
175 bp 6-10 years
200 bp 11-30 years