Taxable and Tax Free Municipal Bonds: Better Value and Higher Yields vs. Corporate Bonds

Asset Preservation Advisors (APA) believes that investors should continue to invest in highly-rated municipal bonds and diversify their income stream by purchasing taxable municipal bonds. Even with market place discussions debating the advantages of adding corporate bonds to a portfolio, APA believes corporate bonds do not offer the value, given current market conditions, of taxable municipal securities. Rather, we believe that investors should continue to add highly rated taxable and tax-exempt municipal securities to their portfolios while avoiding corporate bonds. Taxable municipals bonds are currently providing higher yields than corporates with similar credit ratings and maturities. In addition, an investor's "credit risk" increases with corporate bonds given their historically higher rates of default. Moreover, corporate spreads are so expensive at this time that with some maturities, tax-exempt bonds can yield more than corporates with similar risk profiles. More specifically APA believes:

I. **Taxable Municipal Bonds can provide higher yields than U.S. Corporates.** Concerns that the Build America Bond (BAB) subsidy might be lowered has caused the yield spreads on taxable municipals have widened over the past couple of months. BABs were issued by state and local governments with a guaranteed federal interest subsidy of 35%. Should the subsidy be reduced, most BAB issuers have the right to call the bonds which discourages many institutional investors from holding BAB securities that could be called at a lower price than the premium at which they are currently priced. *Barclays Capital Credit Research* shows that taxable municipal bonds are trading approximately 55bps cheaper than their U.S. Corporate counterparts. In the first half of 2012, comparable taxable municipals were trading virtually the same as the corporate index. Bloomberg data, examined by APA (see Table 1), shows three selected 10-year corporate bonds trading at an average spread of 32 basis points off the benchmark 10-year Treasury. Build America Bonds with the same maturity and similar credit ratings are trading an average spread of 148 basis points off the 10-year Treasury bond and Non-

BAB Taxable Bonds in our sample indicates them trading on an average spread of 121bp to Treasuries. Current market conditions allow investors to potentially increase their portfolio yield without adding additional credit or duration risk.

Table 1: Comparison of Credit Spreads Across Sectors
Spread to 10-year Treasury Bonds

Name	Ratings (MCO, S&P, Fitch)	Type	Spread
Corporate Taxable Bonds, 10-year			
Name	**Ratings (MCO, S&P, Fitch)**	**Type**	**Spread**
Pepsico Inc.	Aa3/A-/A	Corporate Taxable	44
McDonald's Corporation	A2/A/A	Corporate Taxable	20
Carolina P&L	A1/A/A+	Corporate Taxable	31
Average Spread			**32**
Build America Bonds (BAB) Taxable Bonds, 10-year			
Name	**Ratings (MCO, S&P, Fitch)**	**Type**	**Spread**
McCracken County (KY) Schools	Aa3	BAB Taxable	158
New Hampshire Fed. Highway	AA2/AA	BAB Taxable	138
Average Spread			**148**
Non-BAB Taxable Bonds, 10-year			
Name	**Ratings (MCO, S&P, Fitch)**	**Type**	**Spread**
Connecticut State	AA3/AA/AA	non-BAB Taxable	101
Rosmont (IL)	A1/A	non-BAB Taxable	140
Average Spread			**121**
Tax Exempt Bonds, 10-year			
Name	**Ratings (MCO, S&P, Fitch)**	**Type**	**Spread**
Pennsylvania (STATE GO)	AA2/AA/AA+	Tax-Exempt	17
New York (City, GO)	Aa2/AA/AA	Tax-Exempt	54
Average Spread			**36**

Source: Bloomberg and IDC, as of October 16, 2012

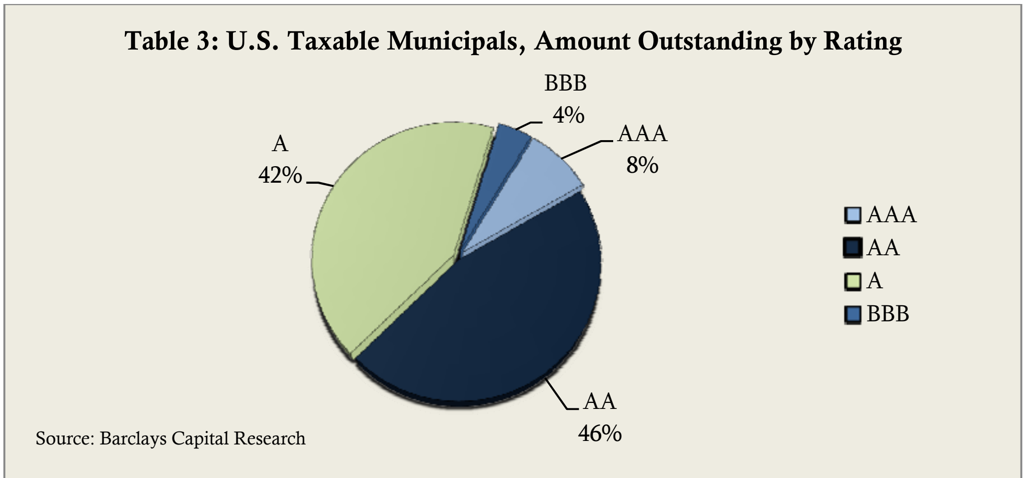
II. Certain Tax Free Municipal Bonds are yielding the same or more than Taxable Corporate Bonds. Tax free municipal bonds are currently trading at more than 100% of Treasuries. Historically, 10-year municipals trade around 85% of the 10-year treasury. The bottom of table 1 shows two tax free bonds that can be purchased, on average, cheaper than lower rated corporate bonds shown at the top of table 1. When we apply a taxable equivalent yield to tax free bonds and utilize the current highest tax rate of 35%, the yields on the tax frees are even more attractive when compared to corporates. If tax reform is not enacted in 2013, then the highest tax bracket will move from a current rate of 35% to 39.5%. Additionally, high earning taxpayers will pay an additional 3.8% on all investment income, excluding tax free bonds. These new rates may boost taxable equivalent yields on all tax free municipal bonds. Table 2 shows that the taxable equivalent yields could increase by 42 and 51 basis points on the two bonds illustrated in the table. Should current markets remain the same and tax reform is not enacted, then in 2013 high earners could find tax free municipal bonds offering more after-tax yield than corporate bonds.

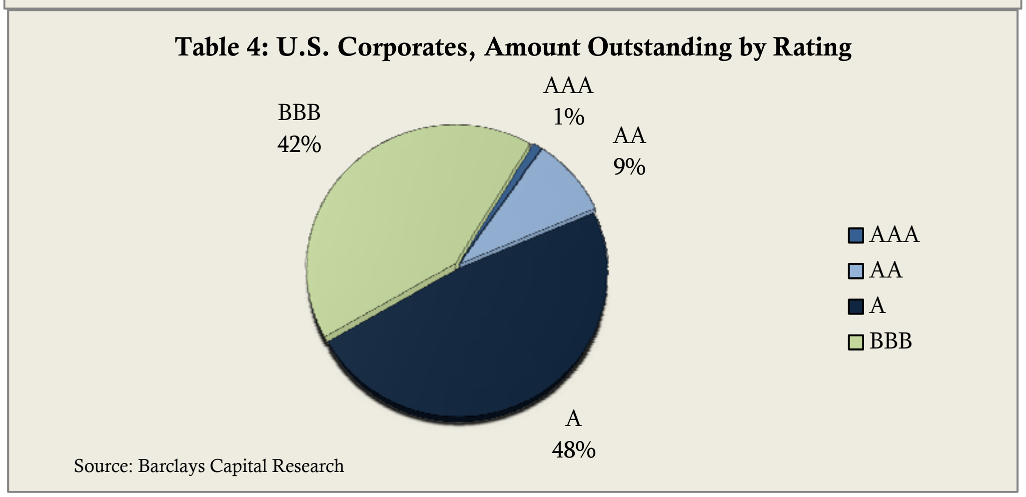
Table 2: Tax Comparisons Under Various Tax Code Proposals

Name of Issuer	Current Yield	Tax Equivalent Yield at: 35% Tax Bracket	Obama 39.5% Tax Rate	39.5% Rate + 3.8% Rate
NY City Bonds, 10YR	2.25%	3.46%	3.72%	3.97%
Pennsylvania GO,10YR	1.87%	2.88%	3.09%	3.30%

Source: Bloomberg and IDC, as of October 16, 2012

III. **Corporate Indexes Ratings Tend Lower when compared to U.S. Taxable Municipal Indexes.** Lower corporate credit ratings could mean increased risk for investors. *Barclays Capital Credit Research* (Tables 3 and 4) reports that wider trading levels are occurring despite taxable municipals having higher ratings relative to the Corporate Index. An examination of a sample $132 billion taxable municipal index shows 88% of holdings in the AA and A rating category. A similar corporate index had 57% of credits with AA and A ratings.





IV. **Corporate Credit default rates tend to be higher than Municipals.** Data examined by APA shows that the number of municipal issuers seeking bankruptcy protection is relatively low and largely confined to localities with small populations and with bonds issued by special land districts. According to data from Bloomberg, from 2000 to July 2012, there was a total of 95 bankruptcy filings by various municipalities. With over 60,000 municipal issuers, the percentage of total bankruptcies was .016%. Additional data from Bloomberg also showed that since 1981, there have been 220 Chapter 9 (municipal) bankruptcies filed in the U.S. This pales in comparison to the 20,000 Corporate issuers seeking protection under the Chapter 11 bankruptcy code during the same time period. Additionally, only 20%, or 43 of the total Chapter 9 cases filed in the U.S. during that time period were from City of County issuers.

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