ASSET PRESERVATION ADVISORS

TAXABLE MUNICIPAL BONDS - BUILD AMERICA BONDS

February 2010

Overview of Taxable Municipal Bonds

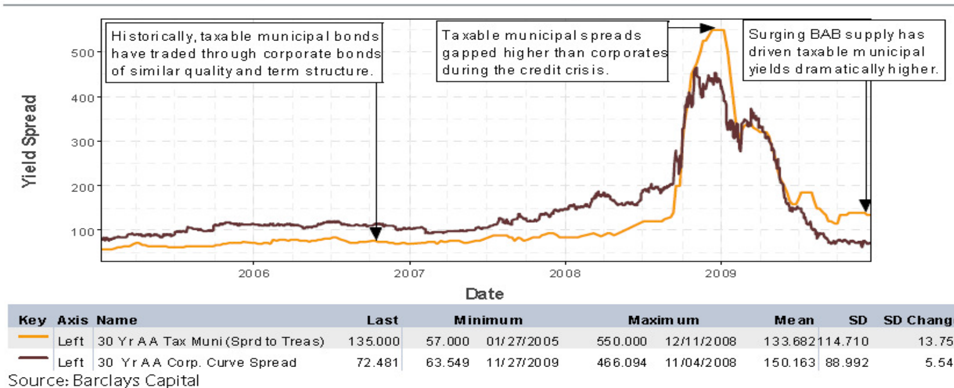
Taxable municipal bonds first entered the market as an outgrowth of the Tax Reform Act of 1986, which established restrictions on the issuance of traditional tax-exempt municipal securities. Taxable municipal bonds can be issued as private purpose bonds that do not qualify for federal tax exemption; as municipal revenue bonds where caps apply; or as public purpose bonds where issue proceeds have exceeded the 10% private use limitation. Typical uses of taxable municipal bond proceeds include financing of athletic stadiums and investor-led housing, replenishing of underfunded pension plans and refunding of previously refunded issues. The single largest issuance of taxable municipals on record was the sale of $10 billion pension obligation bonds by the state of Illinois in 2003.

Taxable municipals generally pay higher interest rates to compensate investors for the loss of tax-exemption, and are protected from early redemption by call protection features. Although taxable municipals do not qualify for federal tax exemption, some may be exempt from state and local taxes in their individual state of issuance.

Taxable Municipals Offer Relative Value when Compared to Corporate Bonds

Taxable municipal bonds possess several qualities that make them particularly attractive when compared to taxable corporate bonds and Treasuries. As the graph below indicates, taxable municipal bonds show compelling spreads over similar term and structure corporate bonds. The higher yields on taxable municipal issues are offered along with lower historical default rates and higher average recovery rates. According to a recent default study by S&P, investment grade municipals have experienced a default rate of 0.16%, versus a 3.76% rate for corporate bonds over a 15-year period. Moreover, high yield municipal issues have experienced a 6.75% default rate over a 15-year period, versus a 27.82% rate for high yield corporate securities.

Figure 10: Spread of 30y Taxable Municipals and Corporates to Treasuries



Key	Axis	Name	Last	Minimum		Maximum		Mean	SD	SD Change
	Left	30 Yr AA Tax Muni (Sprd to Treas)	135.000	57.000	01/27/2005	550.000	12/11/2008	133.682	114.710	13.752
	Left	30 Yr AA Corp. Curve Spread	72.481	63.549	11/27/2009	466.094	11/04/2008	150.163	88.992	5.542

Source: Barclays Capital

Build America Bonds

The American Recovery and Reinvestment Act of 2009 gave rise to a new asset class of taxable municipal bonds known as Build America Bonds (BABs) that have quickly gained notoriety throughout the municipal market. The objective of the BAB legislation was to encourage public works projects and provide fiscal support for state and local governments by significantly lowering net borrowing costs and increasing access to capital markets. The BABs program allows municipalities to issue taxable bonds to finance new capital projects that would otherwise qualify for tax-exempt financing (Refundings do not qualify for BAB issuance). The issuer can elect either to provide investors with a tax credit equal to 35% of the bond's coupon rate, or choose to receive a 35% federal subsidy on the coupon payments periodically made over the life of the outstanding bond. The most frequently issued BABs are structured to provide a direct subsidy payment to the municipal issuer; thus affording issuers a new consistent stream of revenue from the federal government for the entire length of time the bonds are outstanding.

BABs have been well received by the market because of several unique features that appeal to both municipal issuers and investors alike. The direct federal subsidy lowers net borrowing costs, allowing issuers to sell bonds at yields higher than tax-exempt and often at attractive spreads over Treasuries and corporate bonds of similar term and quality. Investors, in return, are given the opportunity to buy high yielding taxable bonds in a familiar class of securities with low historical default risk, thereby potentially abating investor concern with underlying credit quality.

Since the start of BAB issuance, the number of taxable municipal bonds entering the market has more than doubled. At the end of March 2009, there were 34 outstanding taxable municipal bonds with a market value of $23.65 billion, which made up just 0.20% of the U.S. Aggregate Bond Index. At the beginning of January 2010, there were 114 outstanding taxable municipal bonds with a market value of $59.9 billion, comprising 0.44% of the Index. Market participants expect $100-120 billion taxable municipal issuance in 2010. An increase in taxable municipal bond issuance will have a significant effect on the composition of the credit market, particularly in the longer sector of the curve. Taxable municipals are projected to account for 17.2% of the Long Credit Index. Moreover, the proportional effect on higher quality sectors of the market will likely be more evident. As the following table indicates, AA taxable municipals are projected to account for more than 51% of the AA portion of the Long Credit Index.

Figure 14: Taxable Municipal Index as Percentage of Long Credit Index by Rating

	Current Taxable Municipal Rating Breakdown			Projected 2010 Taxable Municipal Rating Breakdown		
	Percent	% of Long Credit Index	% of Long Credit Rating Subset	Percent	% of 2010 Projected Long Credit Index	% of 2010 Projected Long Credit Rating Subset
AAA	6.0%	0.4%	19.5%	13.0%	1.9%	63.4%
AA	41.5%	2.8%	18.9%	67.0%	10.1%	51.6%
A	32.8%	2.2%	5.6%	20.0%	3.0%	7.8%
BAA	19.7%	1.3%	3.2%	0.0%	0.0%	0.0%

Source: Barclays Capital

The Effect of BABs on the Municipal Yield Curve

The inception of BABs into the market has clearly flattened the long end of the municipal yield curve, since the vast majority of BAB issuance has been in 12-year and longer maturities. As a result, even though the Treasury curve has steepened over the past year, the municipal yield curve has been able to counter that trend. According to the table below, the Treasury yield curve has undergone a massive steepening, increasing by 202 basis points since 12/31/08 and 141 basis points since 04/01/09:

TREASURY YIELD CURVE

	1-yr	2-yr	3-yr	5-yr	7-yr	10-yr	20-yr	30-yr	Slope
12/31/2008	0.37	0.76	1.00	1.55	1.87	2.25	3.05	2.69	232
04//01/2009	0.58	0.83	1.16	1.65	2.25	2.68	3.54	3.51	293
01/13/2010	0.37	0.97	1.54	2.55	3.28	3.80	4.60	4.71	434

Source: Thomson Reuters MMD

In contrast, the slope of the municipal curve has actually declined by 45 basis points since 04/01/2009 (just before BAB issuance began) as the following table illustrates:

AAA MUNICIPAL YIELD CURVE

	1-yr	3-yr	5-yr	7-yr	10-yr	15-yr	20-yr	30-yr	Slope
12/31/2008	0.85	2.03	2.47	2.85	3.52	4.42	4.80	5.04	419
04//01/2009	0.50	1.21	2.03	2.50	3.16	3.95	4.49	4.77	427
01/13/2010	0.28	0.87	1.65	2.41	3.04	3.41	3.76	4.10	382

Source: Thomson Reuters MMD

The reason for this pattern is that BABs have sharply reduced the supply of long-term tax-exempt municipal bonds, thereby significantly shortening the average duration of new issues in the municipal market. If the slope of the Treasury yield curve had remained unchanged, the slope of the municipal curve would have most likely declined fairly sharply over the past year. The massive upward shift in the slope of the Treasury curve was simply too much for the municipal market to ignore entirely. Nevertheless, the relative slope of the 1-30 year municipal curve in comparison with the Treasury curve flattened by 239 basis points since 12/31/08 and 186 basis points by 04/01/09.

What to Expect in 2010

Most market participants expect the BABs program to be extended beyond 2010, but a key question is whether the 35% subsidy rate will be maintained. It appears that a case can be made that the 35% rate is higher than needed, given that the municipal market is functioning far more effectively than it was when the Stimulus Package was being crafted. The President's recent budget proposes making the Build America Program permanent rather than letting it expire at the end of 2010. According to Treasury Department officials, the rebate on taxable bonds that qualify for the subsidy sold after 2010 would likely be reduced to 28%, compared to the current rate of 35%. The timing of an announcement of any reduction in the subsidy rate is a crucial factor. If the subsidy rate is lowered, as expected, states and local governments may accelerate BAB issuance this year in an effort to take advantage of the current 35% subsidy rate. A potential increase in taxable municipal supply would further limit the overall issuance of tax-exempt bonds, thereby contributing to the growing supply/demand imbalances currently supporting tax-exempt municipal bond performance.

Costas Kalaitzidis, CFA
Analyst / Portfolio Manager
costas@assetpreservationadvisors.com

Disclosure:

Past performance is not indicative of future results. This material is not financial advice or an offer to sell any product. The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Asset Preservation Advisors, Inc. reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. The information provided in this report should not be considered a recommendation to purchase or sell any particular security. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

Asset Preservation Advisors, Inc. is a registered investment advisor. More information about the about the advisor including its investment strategies and objectives can be obtained by visiting www.assetpreservationadvisors.com.

APA-10-15