

June 29, 2009

## Who Said Muni Bonds Were Boring?

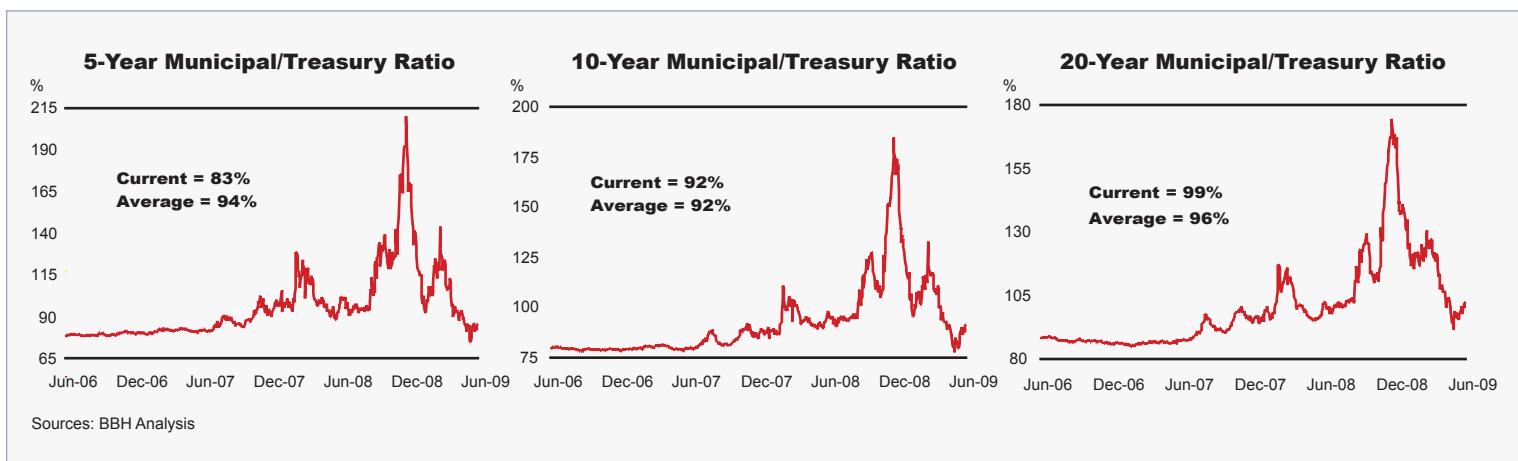
The unprecedented strains in credit markets over the last two years have reached into literally every corner of the U.S. financial markets, proving that even the “mom and apple pie” investment-grade municipal bond market is not immune. The laundry list of challenges includes:

- The failure of the auction-rate preferred market
- Credit down-grades of major monoline bond insurers
- The loss of key market makers (Lehman, Bear Stearns, etc.) and the shrinking balance sheets of remaining players.
- Deteriorating financial condition of a growing list of state and local government issuers

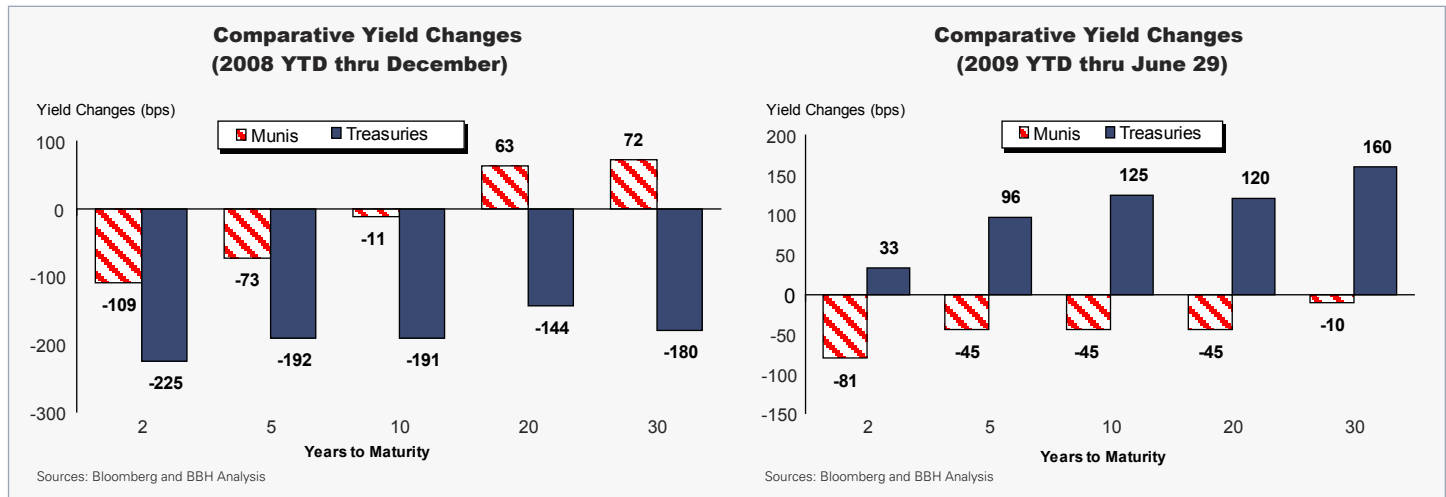
These pressures have manifested themselves in record high Municipal/Treasury yield ratios, widening credit quality spreads, deteriorating liquidity, and elevated market volatility. We will touch on a number of these issues later in the commentary.

### The Round Trip:

Throughout the crisis, municipal bond prices and spreads have followed the well-worn path of investment-grade corporate and ABS sectors, with rapidly widening risk premiums throughout most of 2008 followed by meaningful improvement thus far in 2009. Despite challenging economic conditions and the weakening financial position of many state and local government issuers, high quality municipal bonds have experienced a nearly full round trip in relative performance following an awful 2008.



The strong performance of the municipal bond sector so far in 2009 can be attributed to attractive valuations (record high ratios), manageable supply, strong demand from traditional retail investors and mutual funds, strong demand from non-traditional investors (non-taxable investors) and cross-over buyers, and the early success of the Build America Bonds (BAB) program.



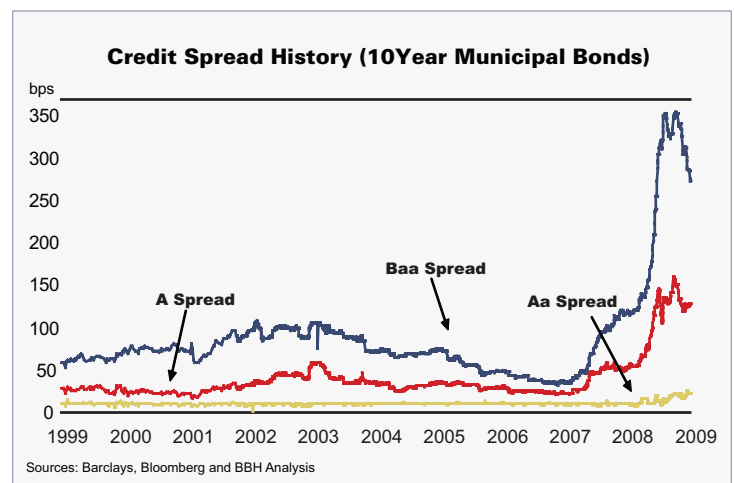
### Weak Fundamentals:

*“Many municipalities are experiencing historic declines in income taxes, capital gains taxes, property taxes, real estate transfer taxes, gasoline taxes, sales taxes, and virtually every other category of revenue. Certain regions are facing acute downsizing of key industries such as automobile manufacturing, financial services, and residential construction.”*

*Taken from the Special Comment: New Era for Municipal Bond Investors by Radford W. Klotz in the most recent BBH Fixed Income Quarterly.*

Signs of weak credit fundamentals in the municipal bond market are everywhere, led by California’s intractable \$24 billion budget gap and the untenable growth in unfunded pension and healthcare liabilities that plague virtually every government entity. In all, state governments alone face a \$121 billion budget gap in the coming fiscal year. Also, according to the Center for Retirement Research at Boston College, state and local pension plans now have approximately \$2.3 trillion in assets to support approximately \$3.6 trillion

in liabilities. Resolution will ultimately come from a combination of significant/draconian spending and service cuts, new and increased taxes, and cuts in the once sacrosanct public sector salaries and retirement benefits. Evidence of deteriorating credit quality can be seen directly in the widening credit spreads depicted in the chart above.



### Build America Bonds — The New Kid on the Block:

Build America Bonds (BAB’s) were authorized earlier this year as part of the American Recovery and Reinvestment Act. The program allows state and local governments to issue taxable debt that qualifies for a 35% federal rebate to the issuer on interest costs. Benefits of the program include:

- The taxable bonds offer access to a wider buyer base of investors than typically invest in more traditional state and local tax-exempt bonds. Interest from pension funds, university endowments, and insurance companies has been very strong thus far. This broader appeal (and increased demand) has reduced the effective borrowing cost for some early issuers by as much as 70 basis points per annum.
- The issuance of taxable BAB's has reduced new supply in the traditional tax-exempt municipal market. This reduced supply has helped extend and further catalyze the muni bond rally that began in late-December 2008.

The BAB market is expected to grow by \$50 billion in 2009 and another \$100 billion in 2010.

### **Pre-Refunded Bonds:**

The performance of the pre-refunded muni bond sector has been entirely consistent with shifting risk premiums in general and the performance of the U.S. Treasury market, more specifically. As the unprecedented 2008 "flight to quality" unfolded, pre-refunded bonds posted exceptionally strong relative performance when compared to the broader General Obligation and Revenue sectors of the muni market. Thus far in 2009, as the "flight to quality" has subsided and reversed and as risk premiums have narrowed, pre-re's have dramatically underperformed both the General Obligation and Revenue sectors. Yields on pre-refunded bonds are now within 5 basis points of their AAA-rated G.O. and Revenue brethren, versus a yield give-up of as much as 70 basis points in late-2008.

### **The BBH Portfolio Response:**

*"...we believe that investors should borrow some of the hard-learned discipline of the corporate bond market to avoid material downgrade and default risk."*

*Taken from the Special Comment: Not Your Parents' Muni Market by Andrew Hofer, BBH Head of Research*

The BBH process of security selection and portfolio construction is well designed for this environment. First and foremost, we are focused on protecting capital while seeking to earn an attractive, low-risk rate of return, irrespective of the prevailing headlines. We continue to upgrade the credit quality of our municipal bond holdings overall, focusing on issuers with strong underlying credit fundamentals, independent of any support from bond insurance, and on high grade General Obligation and essential purpose Revenue bonds. Additionally, where possible, we have moved to eliminate the tactical underweight to the pre-refunded sector by purchasing bonds now that their yield premium has evaporated.

*John P. Nelson  
Managing Director  
Institutional Fixed Income*

Research Assistance: Luke Morosanu

Production: Jaime Pei

This material has been prepared by Brown Brothers Harriman & Co. ("BBH") and is intended for information purposes only. This communication should not be relied upon as financial, investment, tax or legal advice. The services of an appropriate professional should be sought in connection with such matters. The information contained herein has been obtained from sources believed to be reliable, but is not necessarily complete in its accuracy and cannot be guaranteed. Sources used are available upon request. Any opinions expressed are subject to change without notice. Please contact your BBH representative for additional information. This communication has been prepared for use by the intended recipient(s) only. Any dissemination, distribution or copy of this communication without prior approval from BBH is prohibited.