JOHNSON INSTITUTIONAL MANAGEMENT

Bond iQ
Intra Quarter Update

Taxable Municipal Bonds

Taxable municipals have been around for decades, but historically consisted mainly of private purpose bonds issued by less than stalwart credits. The market was small and liquidity poor. The Build America Bonds Program (BAB's) was created as part of the Fiscal Stimulus Plan and allowed many municipalities to issue taxable bonds with an interest payment subsidized by the Federal government. Although the program has expired, the subsidy on bonds issued under it continues. Taxable munis are a meaningful part of the bond market and liquidity has vastly improved.

We believe many BAB's offer a compelling value proposition (both Quality and Yield) and they represent a growing share of bond portfolios at Johnson Institutional Management.

Kurt Terrien

Director of
Sales & Consultant Relations
Johnson Institutional Management
3777 West Fork Road
Cincinnati, OH 45247

248-608-5099
248-840-6268 - Mobile
kterrien@johnsoninstl.com

Good Credit Quality

While many municipalities are experiencing difficulties in the current economic environment, not all BAB's are created equal. Historically, an AAA-rated corporate bond has a higher default rate than an A-rated municipal bond (0.50% 10-year cumulative default rate versus 0.07% over the last 40 years). Though some weaker states have been dominating the headlines and the issuance, such as California and Illinois, many solid municipal credits are also issuing debt – fiscally sound general obligations, essential service revenue and public higher education general receipts. Yields on these better credits are being impacted by the weaker credits, creating value in the market. As always, fundamental credit analysis is required to invest in any municipality and the low historical default rate of municipals should not be used as an excuse for doing your homework.

Superior Valuation

Between April and December of 2010, taxable municipal bonds lagged similar duration Treasuries by over 850 basis points. Lingering concerns about the most problematic issuers and a surge in supply just ahead of the expiration of the BAB's program caused yield spreads to widen. At year-end, the yield spread on the taxable municipal index was 229bp compared to 146bp for the credit index. Investors have begun to recognize the good value in this sector and yields have tightened to 212bp, providing investors 287bp return advantage so far this year. The risk/return characteristics of many taxable municipals are compelling and a scarcity premium is beginning to be established in this segment of the market.