a civil defense of municipal bond investing.

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There are regions of the country where the risk of catastrophic natural disasters such as earthquakes, hurricanes and floods are more prevalent than others. The same concept holds true in the municipal bond market. Just as a seasoned meteorologist with state-of-the-art technology can project the path of a hurricane and recommend precautionary measures, experienced investment professionals equipped with the proper tools and knowledge can take steps to avoid the riskier regions of the market.

Prudently managed municipal bonds remain an integral 'safe haven' component for investors seeking safety of principal, tax-exempt income and lower volatility for their overall investment portfolio. Since the beginning of the recession three years ago, municipal investors sheltered by well-designed portfolios have largely side-stepped the majority of market tumult and enjoyed reasonable returns, despite the ultra-low interest rate environment. How? Taking a look at some key dynamics in the market will provide some clarity.

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generally speaking, are municipal bonds still safe?

Just about every component of the capital markets have been called into question over the past three years, and increased scrutiny over the municipal bond market has received its fair share of ink in the financial media. Some headlines have called into question municipal bonds as a safe investment noting increased price volatility and credit downgrades during the recession. Upon closer look, much of the volatility can be traced directly to the supply and demand influences created by the broader financial crisis. For example, during 2008, high-quality municipal bonds served as a primary source of liquidity for institutions prior to federal government intervention. At the end of 2010, municipal issuers flooded the market with new bonds ahead of the expiration of the heavily subsidized Build America Bond program, contributing to the dearth of issuance during 2011 and further disrupting normal supply and demand factors.

As has been widely reported, state and local government entities across the nation have struggled with dramatic revenue declines, underfunded pension liabilities and, in some cases, draconian budget cuts. However, media scrutiny has amplified concerns by indiscriminately casting doubts on practically all forms of municipal bonds and the underlying issuers. Of particular note is Meredith Whitney's December 2010 appearance on CBS's ***60 Minutes*** highlighting her concerns of looming fiscal jeopardy for states and municipalities, with predictions of widespread credit defaults.

While legitimate questions have been raised, it is important to note that the $2.9 trillion municipal bond market is composed of more than 30,000 different bond issuers and more than 70,000 outstanding bond issues. Bad apples should not be allowed to spoil bushels of otherwise healthy apples. A vigilant portfolio manager knows how to make the most of the healthy fruit, avoid the bad fruit and, most importantly, when to prune. The same professional also knows it is better to rely on a soundly constructed portfolio than to make wholesale portfolio changes in an attempt to predict the direction of interest rates.

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what are some of the elements causing skittishness around municipal bonds?

Recently the terms 'bankruptcy' and 'default' have been used by some politicians as levers to repair structural budget gaps. Such terms clearly do not inspire investor confidence. Industry consensus indicates the mere suggestion of a strategic bankruptcy or default by a municipal issuer can easily backfire and serve as a trigger for a credit rating downgrade. This is true even if the intent is only to gain labor contract concessions or to present arguments for raising taxes. Consequently, many municipal governments have a newfound political will to resolve budget gaps, increase transparency and address long-range problems such as pension liabilities, rather than risk the possibility of being shut out of the capital markets for future funding needs.

From 2000 to 2009, the cumulative default rate for all rated municipal bonds, including those rated below investment grade, ranged from 0.04% - 0.29% based on reports from all three major rating agencies. Few people question the need for the majority of the public services that states and local governments provide. Therefore, municipal investors can remain confident in the vast majority of tax-backed and essential service revenue bonds.

Still, investors should remain wary of municipal bond issues used to finance projects that may be deemed non-essential to the life and welfare of the communities they serve. During 2009, Moody's reported 183 municipal defaults out of approximately 70,000 outstanding bond issues. Of those 183 defaults, 99 were concentrated in issuances of the Florida Community Development Districts and were backed by condominium developments. Even during the nation's real estate bull market, most informed investors would have considered these issues to be speculative and not safe haven investments.

We acknowledge that even if investors stick to the safer sectors of the municipal market, some issuers pose greater risks than others. As always, the key is to continually sift through the rhetoric for the underlying facts in order to identify potential concerns, as well as take advantage of the opportunities.

Much of the media concern over the municipal market is associated with underfunded state and local government pension plans. While these concerns are shared by many, they do not imply insolvency or default. In fact, many states continue to meet or exceed the recommended regulatory funding levels. This is particularly true in states where many of our clients live, such as Georgia, Tennessee, North Carolina, Florida and Texas. Moreover, governments have begun to take action to reduce the pension liabilities and/or grow assets, including increasing employee contributions and reducing benefits.

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municipal market outlook.

what are the key themes going forward?

There are four trends we believe should be important going forward:

Increased Tax Efficiency Most pundits agree the future holds some form of income tax increase for taxpayers. The need to address federal, state and local government deficits will likely bring this increase in tax rates to all levels of government, especially for upper-income taxpayers. As income tax rates move higher, tax-exempt income becomes even more economically attractive to municipal investors.

Sustained Municipal Bond Demand American baby boomers are moving toward retirement, and their investing patterns are expected to shift toward heavier weightings in fixed income investments. This trend will result in continued investor demand and a strong secondary market for larger, high-quality municipal bonds. Also, the federal government has already shown a willingness to bypass the tax-exempt municipal market through the direct subsidy of the taxable Build America Bond program. A resurrection of this or a similar program would reduce traditional tax-exempt issuance, likely creating more value for the existing supply.

Less Secondary Market Liquidity for Smaller Issuers Prior to the financial crisis, thousands of smaller, lesser-rated municipal borrowers utilized 'AAA' bond insurance, essentially providing their bonds with 'market wide' liquidity, for trading purposes. With the municipal bond insurance industry effectively debilitated, these bonds have generally experienced weak trading value compared to prior years, particularly when compared to larger, well-known borrowers.

Wider Price Spreads on Municipal Bonds Three years after the financial crisis, there are fewer brokerage firms and less capital allocated for dealers to carry bond inventories. As a result, prices vary greatly between broker/dealer firms able to act as intermediaries (matching buyers and sellers simultaneously) and those firms that act as bidders (positioning bonds in an inventory with a comfortable margin of resale at a later time). Savvy professionals can distinguish the differences in the market place and are also able to negotiate better prices.

Broadly speaking, we believe smaller, infrequent bond issuers will have tougher municipal market paths in the future. This may be particularly true of issuers depending on state budget transfers to

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balance their budgets, states with heavy labor union presence and governments that rely on rising real estate valuations and speculative growth to balance their budgets. Conversely, there can be distinctive opportunities to add significant value when smaller, but fundamentally sound issuers are revealed through diligent research. An example would be 'double barreled' bonds, such as the Development Authority of Fulton County (GA) revenue bonds for the Georgia Tech University Foundation Funding Corporation. This issuer not only has a pledge of revenues from a Georgia Tech University project, but also an appropriations guarantee from the state of Georgia Board of Regents, giving the bonds a solid AA+ rating. At first glance, this offering may look ordinary and pedestrian, but upon closer scrutiny, the 'double barreled' protection in exchange for a reasonable yield, provides an advantageous risk/return exchange.

our approach.

Like everyone else, our approach was tested during the nation's 2008-2010 financial crisis. We are pleased to report that our clients' municipal bond portfolios withstood a manageable degree of volatility during the height of the credit crisis.

Our strategy focuses on creating a portfolio structure that results in a high-quality portfolio with diversification of credit risk and interest rate risk, which in turn lowers the liquidity risk of a municipal portfolio (terms we will investigate further below). The overall duration of our typical portfolio falls within the intermediate range of three to seven years; adjustments to duration are managed through the reinvestment of interest along with proceeds from called or maturing bonds and as contributions or distributions are made to the client's municipal allocation.

We employ a buy-and-hold approach in order to limit trading costs, particularly since such costs can easily outweigh the benefits. However, an effective portfolio manager also takes advantage of periodic anomalies and opportunities to make portfolio changes when conditions warrant. The key is to identify the exceptions from the rule, and to be highly selective in purchasing bonds from the tremendous number of bond offerings we comb through each week.

Our primary focus for client purchases is on general obligation and essential service revenue bonds. However, when appropriate, bonds backed by carefully selected, high-quality, "quasi-essential" services (i.e. airports, hospitals, private education, etc.) are added for diversification and income. Examples include issues backed by Piedmont Hospital in Atlanta or Vanderbilt University.

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We also believe each bond within a portfolio serves a purpose, and careful consideration must be given to the overall portfolio to determine if changes are warranted. For example, higher interest rates have been predicted for over two years. If the bonds with the longest final maturities of a structured portfolio had been removed, the portfolio's ability to generate sufficient income would have been significantly impacted with funds invested in near-zero interest rate money market funds. A soundly constructed portfolio should provide ample reinvestment opportunities with maturing positions to reinvest as rates rise.

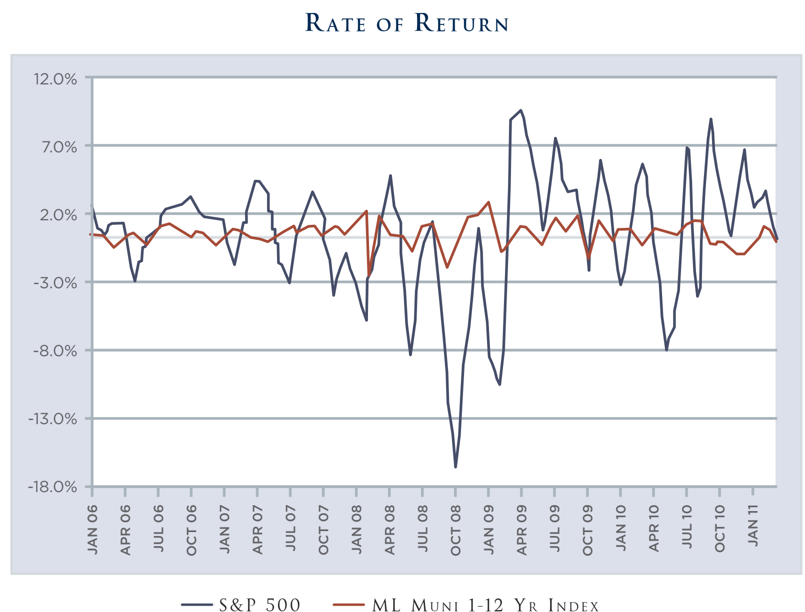
Our views on the municipal bond market are shaped by the wealth of information and the insights provided by our stable of investment advisors, as well as our numerous sell-side and independent resources. Over the last 25 years, the professionals at DTC have developed relationships with a talented and diverse network of local, regional and national municipal broker-dealers and underwriters. Without such relationships, it would be very difficult to thoroughly compare and contrast multiple bond issues or maintain an up-to-date knowledge of the marketplace for negotiating better bond prices.

Our daily presence in the municipal market provides our clients access to securities with strong relative value, after surveying the ever-changing landscape of primary and secondary market offerings. Over the last three years, our annual trading volume has averaged over 500 transactions representing over $175 million in market value.

the contribution of municipal bonds.

stability.

Municipal bonds remain a prudent place for investors seeking to lower the overall volatility of an investment portfolio. This can be illustrated by comparing the rate of return volatility of an intermediate municipal bond index to the S&P 500 over the past 5 years. This relative price stability is critical to investors that may need to liquidate investments at any given time, either for anticipated or unanticipated reasons.



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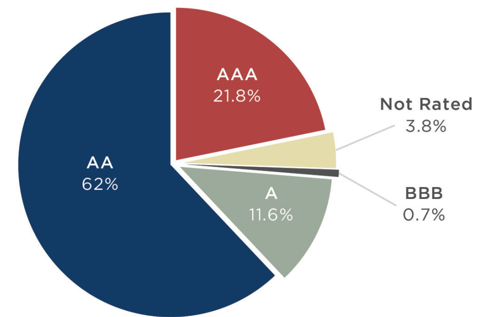
credit risk.

strong credit investments.

Credit risk is the threat posed by a borrower's inability or unwillingness to meet debt service obligations in a timely manner. Though the credit ratings industry has come under scrutiny during the financial crisis, we believe the rating agencies continue to provide useful tools for credit analysis. The use of ratings is one way of assessing credit risk. However, ratings alone are no substitute for credit analysis. In fact, opportunities can be found in smaller "non-rated" bonds where the fundamentals are sound but, due to the size of the deal, the issuer could not economically justify the costs of applying for a credit rating. The Credit Ratings Category Overview chart shows the recent composition of the ratings for our clients' municipal bond holdings. We should note these figures include both holdings we have purchased for clients and positions transferred into client accounts from other institutions. When bonds are transferred into client accounts, we continually assess whether or not those positions should be held as a part of the overall portfolio or how to adjust positions that are no longer marketable.

DTC Municipal Composite
Credit Ratings Category Overview

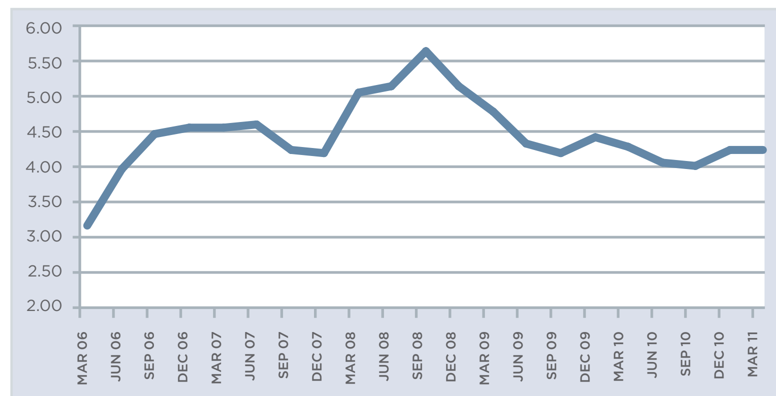


interest rate risk.

measured by duration.

Interest rate risk, as measured by duration, indicates the price sensitivity of a bond or portfolio of bonds relative to a change in interest rates. The longer the duration, the more sensitive the principal value is to a change in interest rates. As rates increase, the market value of bonds decreases, and vice versa. If a bond portfolio has an average duration of four years, a 1% change in interest rates would produce approximately a 4% change in the principal value of the bond portfolio. The graph to the right represents the weighted average duration of aggregate DTC client portfolios over the last five years. The most recent average was 4.24 years.

DTC Municipal Composite
Weighted Avg. Duration (years)



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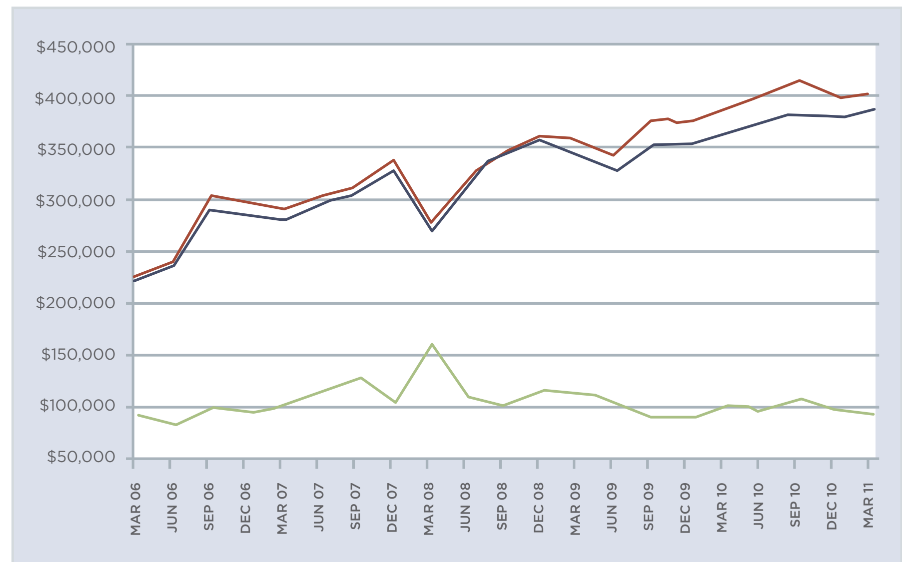
liquidity risk.

Liquidity simply means the ability to convert a holding to cash. The chart on the right reflects that aggregate DTC client portfolio holdings have consistently yielded premium market valuations even in challenging markets. Between 3/31/06 and 3/31/11, the aggregate market value has averaged 103.8% of face value, including during the historically disruptive period of the third quarter of 2008. Compared to massive price volatility of the S&P 500 Index during the same period, the price stability of aggregate client holdings exhibited adherence to our investment strategy, as we assume our clients may need to liquidate holdings at any given time for anticipated or unanticipated reasons.

DTC Municipal Composite
Face Value and Market Value (in Thousands)



diversification.

credits, maturities & sectors.

Risk management is a key component to any fiduciary's responsibilities and a key element for well-structured portfolios. This entails diversification of credits, maturities, economic sectors and collateral. Diversification of credit prevents a single investment from ruining portfolio market value. Diversification of maturities provides a hedge against changes in the level of interest rates. Diversification of bond sectors such as general obligation, sales tax-supported, electric or water utility or airport revenue bonds reduces business risk.

Understanding the role of the municipal bond allocation in each client's overall investment strategy is central to our municipal bond strategy as we endeavor to combine the requisite amounts of safety, income and liquidity.

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conclusion.

the case for professional management.

Projecting municipal defaults is similar to predicting earthquakes. Although we have never been in the prediction business, we have always subscribed to the practice of not building a municipal portfolio on fault lines. In that context, we remain confident that the vast majority of municipal bonds remain fundamentally sound, despite dramatic economic events of recent years — primarily due to each state and local governments' legal powers to tax and set fees for the purpose of debt repayment. In many states debt service is not only contractually required, but is also constitutionally protected. Additionally, many state and local governments bound by balanced budget amendments were forced to cut spending during the past three years. Now that income and sales tax revenues have rebounded to near pre-recession levels, the higher-quality issuers are positioned to replenish reserves and reduce outstanding debt. An illustration of this is the state of Tennessee — one of the few states without an income tax, and therefore reliant on more economically sensitive sales tax revenues. In May 2011, Standard & Poor's affirmed the state's AA+ rating and issued a positive outlook on the credit based on a stabilizing economy and prudent fiscal management.

We believe a professionally managed approach can add value through institutional trade execution and ongoing oversight to greatly assist in mitigating credit, interest rate and liquidity risks. We are also confident that a well-structured portfolio provides the opportunity to make incremental, rather than wholesale changes to municipal holdings as market conditions and/or client needs change over time.

Professional managers have long recognized the opportunities and perils in the municipal market that have only recently become more evident to the investing public. Now more than ever, buying municipal bonds without creating a purposeful structure or understanding the underlying credit is as dangerous as building your dream home on a fault line or in a floodplain. One may go years without incident, but disaster lurks; make sure you are prepared. ■