



STANDISH
Tax Sensitive Fixed Income

Build America Bonds Gather Momentum

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Build America Bonds – Federal Stimulus Arrives for State and Local Capital Projects

The federal stimulus plan provides a simple and effective new tool for state and local governments to finance needed capital projects. Under the Build America Bond (BAB) program, states and cities now have the option to offer federally-subsidized taxable bonds, thereby reducing financing costs and gaining access to the broader corporate and sovereign bond markets.

Build America Bonds have grabbed attention in the fixed income markets. We expect the mechanism will become increasingly popular and may develop into an effective substitute for many tax-exempt governmental bonds. Before the program expires on January 1, 2011, we estimate total issuance could be as high as \$150 billion, based upon pace of issuance, historical purpose, and favorable all-in funding costs.

The BAB program allows states and local governments to shift capital financings to the taxable fixed income markets from the tax-free municipal markets, reducing overall supply of tax-free bonds (at least for the next two years). As a result, given the smaller supply potential for tax-exempt bonds, there is the corresponding potential for boosting prices of traditional tax-exempt municipal bonds if demand outpaces supply.

What Are Build America Bonds?

In early April 2009, the Department of the Treasury and the IRS released rules for Build America Bonds, unleashing the first wave of new supply. BABs quickly gained traction, and now make up nearly 30% of all municipal supply. Most BABs issued so far in 2009 have qualified for direct federal subsidies equal to 35% of total interest payable over the life of each bond. Federal interest subsidies are paid to issuers semi-annually for fixed-rate BABs and quarterly for floating-rate BABs. Issuers can pledge the stream of federal subsidies to the payment of debt service, but they are not required to do so. In addition, issuers are authorized to securitize the future stream of federal subsidies. Interest payments received by investors are subject to federal income taxes, but, in several instances, exempt from state income taxes.

Build America Bonds may be used to finance any governmental project for which tax-exempt bonds may be issued. Projects financed with private activity bonds are excluded. Among the purposes cited in the Treasury's announcement are: schools, roads, transportation infrastructure, government hospitals, water and sewer projects, energy projects, governmental housing projects, and public utilities. There are no limits on the total dollar amount of BABs that may be issued. Advantages of BABs for Eligible Issuers

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Lower Net Funding Costs

The generous federal subsidy reduces an issuer's effective interest rate and lowers debt service over the life of the BABs. Under the BAB program, the federal subsidy of 35% of interest costs is directed solely to state and local issuers, additionally, buyers pay the full federal tax on interest income and, therefore, receive no

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tax benefit. In contrast, issuers of tax-exempt bonds sell debt at a lower tax-free rate, effectively receiving a smaller market-based interest subsidy (currently 5% to 15% of interest costs for issuers rated triple-A). Here, the buyer also receives a tax benefit, paying no federal income tax on the interest.

Access to Broader Capital Markets

We have often noted an innate imbalance between supply and demand in the municipal markets. Capital projects financed with municipal bonds mostly have long lives, and the bulk of new issuance is clustered among long maturities. At the same time, buying patterns for tax-free bonds are heavily concentrated among maturities of 15 years and less, reflecting demand from retail investors.

Build America Bonds bridge the mismatch between buyers and sellers, which has been particularly acute over the last 18 months, by allowing governmental issuers to tap natural buyers of long-term assets. Pension funds and liability-driven investment (LDI) programs, are especially interested in the long duration “sovereign” BABs.

BABs will likely be a welcome addition to the relatively small amount of long-maturity bonds currently available in the taxable fixed income markets. As of October 31, 2009, securities maturing in 25 years or longer were only 4.7% of the Barclays Capital U.S. Aggregate Index,¹ with credit contributing 3.1% and government bonds 1.6%. As BABs are issued, they, too, will be added into the credit portion of the Aggregate Index, so investors that measure returns against that index may be inclined toward considering the purchasing of BABs in order to match up with index exposures.

New investors from the taxable markets may find attractive the broad taxing power, high-grade credit quality and substantially lower historic default rates that prevail among most BAB issuers.

Should Taxpaying Investors Buy BABs?

We expect BABs will be favored by issuers and investors alike. At current trading levels for taxable BABs and comparable tax-exempt municipal bonds, we believe that investors will generally find the tax-exempt municipal bonds to offer more favorable after-tax yields.

For investors who pay taxes at the highest federal marginal rates, yields after federal taxes from Build America Bonds have so far been substantially below tax-free yields from comparable municipals. This is because the federal subsidy from BABs passes to the issuer rather than to the investor. Or, to put it another way, lower financing costs for the issuer translates directly into lower coupon income for investors.

Meanwhile, Back in the Municipal Bond Market

Since early spring, we have witnessed a strong rally in long-dated municipals. Between January 1, 2009 and October 31, 2009, yields on triple-A rated tax-exempt bonds maturing in 15 years or longer dropped by nearly one percentage point, even as long Treasury rates were rising by a similar magnitude. We also saw ratios between municipal and Treasury yields, which have been stubbornly high this year, fall sharply.

BAB issuance to date has likely contributed to the rally in municipals by removing a sizeable portion of new issue municipal supply and tipping favorably the balance between supply and demand.

Not all buyers of municipals, however, can buy taxable BABs. In particular, open-ended tax-exempt mutual funds, which own 17.6% of all municipals,² are mostly precluded from buying taxable BABs. Tax-exempt bond funds will continue to buy from a downsized inventory of tax-free bonds, so the increased competition for a smaller number of bonds should boost municipal valuations further.

The development of a market for BABs should bring valuations between taxable and tax-free municipals more closely in line as other major buyers, such as property and casualty insurers choose between BABs and

¹ The Barclays Capital U.S. Aggregate Index represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.

² Source: Federal Reserve Statistical Release for Flow of Funds Accounts as of September 17, 2009 for Q209.

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tax-free municipals. A deeper BAB market should allow more flexible investors to ultimately become indifferent to receiving either BAB interest taxed at the highest marginal federal rate or tax-free municipal interest. For example, at a 35% tax rate, the yield from a general obligation municipal may eventually fall to 65% of the yield from a comparable general obligation BAB. Because of imbalances in supply and demand noted above, the municipal's yield is currently above what the tax rate alone would indicate.

Political Support Growing as Supply Expands

Although sales of BABs are currently set to expire at the end of 2010, there appears to be strong support in Congress and in the administration to extend the program, perhaps permanently. In a highly favorable press release in early October, the Treasury Department noted the positive market reception for BABs, calling the program "an unsung hero of the economic and financial recovery." According to Treasury's October 5, 2009 tabulations, nearly \$36 billion of BABs were sold by issuers across 39 states.³ An additional \$12 billion were issued later in October, bringing the total through November 1, 2009 to almost \$48 billion.

In the early stages the stimulus delivered by BABs has been relatively concentrated with two states, California and Texas, grabbing 40% of the total through October 5, 2009.⁴ Many of the larger states, such as New York, are scheduled to sell significant volume of BABs in the coming months. As the program matures, BAB supply will likely mirror, more closely, the state distribution in the municipal markets.

Will BABs Replace Tax-Free Municipals?

While BABs hold financial advantages for governmental issuers, it is unlikely that BABs will completely supplant tax-free municipals.

As currently enacted, BABs can be used only for governmental purposes. Non-governmental municipal bond issuers such as not-for-profit hospitals and private colleges are currently denied access to BABs.

Additionally, BABs may not be used to refinance existing debt. According to data from Thomson Reuters, refundings over the last decade have ranged from 9.7% of annual supply in 2000 to a high of 32.0% in 2005.

Educating New Buyers

The largest BAB issues, such as the State of California's \$5 billion sale in April 2009, are already included in several popular bond indexes. Consequently, many new investors are becoming more familiar with the ins and outs of municipal credit analysis. New buyers can also avail themselves of the services of investment advisors with municipal credit research capabilities in order to build a diversified basket of BABs.

Conclusion

For years there has been tension between Washington and state and local issuers over the subsidy provided to public financings via the tax-exempt municipal bond market. Federal authorities, particularly the Treasury Department, grudgingly tried to limit foregone tax revenues by narrowing the purposes for which tax-free bonds could be issued.

By rolling out BABs, the federal government explicitly recognizes the importance to the national economy of state and local capital financing, supporting those financing needs with a direct subsidy. The BAB program has the potential to improve marketability for tax-exempt municipal bonds as well. Nevertheless, barring an extension of the program, new BAB issuance comes to a halt after 2010, which in our view may hamper efficient pricing and trading of BAB bonds in the long run.

³ Source: US Treasury press release, October 5, 2009, "Treasury Chief Economist Congressman Range is Tout Benefits of Build America Bonds."

⁴ Source: Thomson Reuters

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