



STANDISH
Tax Sensitive Fixed Income

Why Municipal Bonds Can Be An Attractive Investment for Corporations

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Introduction

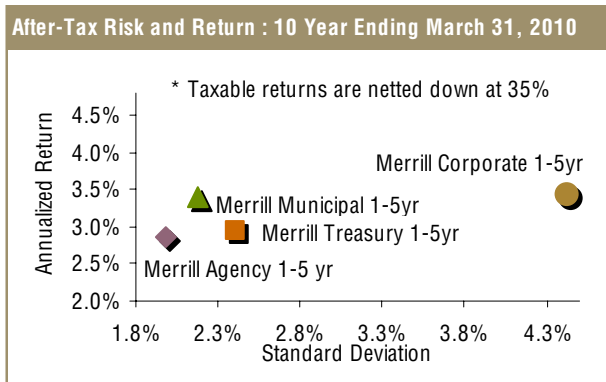
Successful domestic companies, as defined by their profitability, share their success by paying federal and state income taxes. However, corporations that are tax aware will attempt to minimize their tax liability, and will often invest in municipal bonds as the interest income on municipal bonds is exempt from federal (and potentially state) income taxes. As the chart below illustrates, municipals bonds outperformed on a total return and volatility basis over a 10-year period, providing a powerful argument for munis. Our discussion will include the potential use of tax-exempt and taxable bonds to attempt to maximize after-tax return within a corporate operating portfolio.

Corporate operating portfolios typically maintain money market funds for maximum liquidity, but complement them with a high quality tax-exempt bond portfolio invested along the 1-5 year portion of the yield curve. Although money market funds provide a strategic liquidity role for cash management purposes, corporations typically maintain enough liquidity to allow a portion of the operating funds to extend along the yield curve to optimize after-tax income and return.

Credit Quality of Municipal Bonds: In addition to certain tax advantages, municipal bonds have a stronger credit profile than taxable bonds in the context of default rates. As the chart below illustrates, a triple-A rated taxable corporate bond has a similar default rate as a triple-B rated tax-exempt bond over the period noted.

Historically, municipal bonds have been stronger credits than corporate bonds for the following reasons:

- Debt payments are supported by the taxing authority of the issuer, or a dedicated tax or an essential service revenue stream
- Fiscal management flexibility via revenue and spending adjustments
- Lower default history



Source: Merrill Lynch; Bloomberg as of March 31, 2010

Municipal & Corporate Default History

	Moody's	
	Municipals	Corporates
AAA	0.00%	0.50%
AA	0.03%	0.54%
A	0.03%	2.05%
BBB	0.16%	4.85%
Investment Grade	0.06%	2.50%

Source: Moody's Cumulative default rates within 10-years of original issue, by rating category, from 1970 to 2009

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Roll-Down Value of Tax-Exempt Yield Curve

Given the historic steepness at the short end of the tax-exempt yield curve, the yield curve “roll down” can provide a significant contribution to total return. Strong demand from money-market funds for SEC rule 2a-7 money market eligible bonds has contributed to the steepness in this area of the yield curve.

Roll Down Example

Yield curve roll-down plays an integral role in portfolio total return, particularly in the 1-5 year portion of the yield curve, which is traditionally the steepest section along the full yield curve. By taking advantage of yield differentials on the yield curve, you can capture greater yield while still managing duration exposure.

For example, on March 31, 2009, the AA rated Municipal Market Data “MMD” Index with a remaining maturity of two years had a yield of 1.09%, while the Index with a remaining maturity of one year had a 0.63% yield. The yield difference represents the “roll-down value” of 46 basis points. One year later, on March 31 2010, that 2-year remaining maturity bond became a 1-year remaining maturity bond with a yield of 0.39% (representing a decline of 0.70% over a one-year holding period). In this example, the combination of the higher yield and roll-down value from a 2-yr bond provides a significant advantage over simply buying and holding a 1-year bond (0.63%), particularly in a declining interest rate environment.

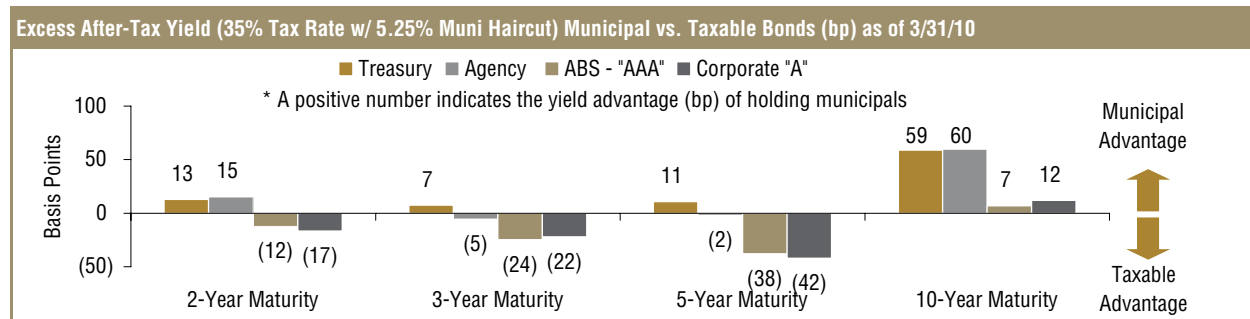
Yields on 1 & 2 Year AA Municipal Bonds		
Remaining Maturity	As of 3/31/2009	As of 3/31/2010
1 Year	0.63%	0.39%
2 Year	1.09%	0.91%
Roll-down Value	0.46%	0.52%

Source: Thomson Reuters as of March 31, 2010

To continue capturing roll-down value, and to further contribute to portfolio return, the next step is to sell the bond with now one year left to maturity (which now becomes an eligible investment for, and can attract bids from money market funds) and purchase a bond along the 2-5 year portion of the yield curve, thereby attempting to pick up incremental yield from a longer-maturity bond while also using the strategy to help manage overall yield curve and duration exposure. Thus, purchasing a bond with a two-year remaining maturity on March 31, 2010 versus a one-year remaining maturity allows a higher yield differential, or roll-down value, of 52 basis points. Of course, in an increasing interest rate environment, the price depreciation of the 2-year bond could offset the yield differential on this strategy.

Tactical Crossover Opportunities Into Taxable Bonds

Strategically, tax-exempt bonds provide better taxable equivalent yields (“TEY”) relative to taxable bonds for corporations in the 35% tax bracket. However, there are periods of time when taxable bonds are attractive on an after-tax basis and can potentially add incremental after-tax income and return to a corporate operating portfolio, particularly if the investor’s effective tax rate is less than 35%. The crossover trade is tactically executed at times when there is an attractive risk adjusted yield pick-up from taxable bonds over tax-exempt bonds. See chart below.



Assumes 35% tax bracket

Source: Bloomberg, Thomson Reuters, and JPMorgan

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As observed by Standish, tax-exempt bond price movements typically lag taxable bonds where the beta (relative price change) between tax-exempt bonds and taxable bonds is approximately 65% historically. For example, if taxable interest rates increase 100 basis points, munis increase only 65% and vice versa when interest rates decline. The 65% beta indicates that munis lag in performance to taxable bonds, which is a positive in a rising interest rate environment and negative in a falling interest rate environment. So the ideal period of time for the crossover trade into corporate bonds is when there is an attractive after tax yield pick-up and interest rates are either steady or falling. The goal of the crossover strategy is to pick-up incremental return while being consistent and in compliance with the client's risk tolerance.

	2 Year		3 Year		5 Year		10 Year	
	After-tax	Muni	After-tax	Muni	After-tax	Muni	After-tax	Muni
	Yield	Advantage	Yield	Advantage	Yield	Advantage	Yield	Advantage
Municipal "AAA"	0.79	-	1.10	-	1.77	-	3.09	-
Treasury	0.66	13	1.03	7	1.66	11	2.50	59
Agency	0.64	15	1.15	-5	1.79	-2	2.49	60
ABS - Credit AAA	0.91	-12	1.34	-24	2.15	-38	3.02	7
Corporate "A" Indus.	0.96	-17	1.32	-22	2.19	-42	2.97	12

Source: Bloomberg, Thomson, and JP Morgan as of March 31, 2010

Favorable Accounting Treatment Under FAS115?

Corporate treasury staffs are confronted by increased auditor scrutiny in this heightened age of regulation. Under FAS 115, corporate investors categorize their portfolio investment holdings as either (i) buy and hold, (ii) available for sale or for (iii) trading. Investors typically select "available for sale" status, allowing market value changes to flow through retained earnings on the balance sheet. In periods of widening credit spreads and/or rising interest rates, market values on bonds decline and as a result may need to be categorized as Other Than Temporarily Impaired (OTTI) for accounting purposes. In this case, the market value write-down flows through the income statement - an unwanted consequence. A bond may be earmarked OTTI if its market value declines by a predetermined amount (15-20%) over a predetermined period of time (typically 6 months). However, if the portfolio is elected to be Buy and Hold, the OTTI issue may not pertain if it can be determined that the company has the intent and wherewithal to hold the bond to maturity. The buy and hold strategy can be achieved through the construction of a laddered portfolio. Although buy-and-hold does not categorically rule out the potential for a bond to be deemed OTTI, it can minimize the potential outcome.

Additional Tax Considerations; the 2% "De Minimus" Rule

Interest paid on corporate debt generally qualifies as a business expense. However, the IRS disallows such interest deductions if the bond proceeds are used to invest in tax exempt obligations. It is the intent of the Internal Revenue Service ("IRS") to avoid possible abuses in which tax-advantaged financing (through the deductibility of interest on corporate debt) is used simply to fund the purchase of tax-advantaged assets.

Tax exempt securities have long been an attractive asset class for companies and other institutional investors looking to maximize after-tax income on their operating portfolios. However, companies that issue debt need to be aware of IRS regulations that may limit the size of their tax exempt portfolios. Fortunately, the IRS offers significant leeway for companies in this situation, including the 2% "de minimus" rule.

The IRS's main exception for investors with outstanding debt to hold tax-exempt bonds is the IRS 2% de minimus rule. Broadly speaking, if a company's tax exempt portfolio constitutes less than 2% of its total assets, the IRS will view the tax exempt portfolio as "insubstantial", and the tax-deductibility of interest on corporate debt will be unaffected.

We believe the lesson learned here is to not automatically exclude tax exempt securities, but to establish a muni portfolio up to the 2% de minimus in the effort to maximize after tax return on the allowable assets.

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Conclusion

We believe corporate operating portfolios should consider tax-exempt bonds for the following reasons:

- Liquidity - currently, strong demand for short-term tax-exempt bonds
- Credit - high-grade municipal bonds have lower default rates
- Tax-efficient - attractive after-tax yields
- Total return - enhanced after-tax total return
- Volatility - municipal bonds historically have lower volatility

Standish has a dedicated tax-sensitive fixed income group that focuses on providing clients with highly-personalized, customized portfolios that seek to achieve the highest after-tax returns while providing liquidity, preserving capital and maximizing total return. As successful tax aware companies maximize shareholder value by minimizing tax liabilities, there is a greater need for managing the credit and liquidity risks, and capturing the crossover opportunities between tax-exempt and taxable products.

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The Merrill Lynch Municipal 1-5 year Index is an unmanaged index consisting of public municipal obligations having maturities from 1 to 4.99 years and reflecting total return. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The Merrill Lynch Corporate 1-5 year Index is an unmanaged index consisting of corporate obligations having maturities from 1 to 4.99 years and reflecting total return. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

The Merrill Lynch Treasury 1-5 year Index is an unmanaged index consisting of all public U.S. Treasury obligations having maturities from 1 to 4.99 years and reflecting total return. This unmanaged index does not reflect fees and expenses and is not available for direct investment.

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