

## Municipal Market Bulletin

Since early November, municipal bonds have experienced a meaningful sell-off which has raised headlines in the press and caused considerable concern on the part of investors. We would like to take this opportunity to address these developments and emphasize our investment approach.

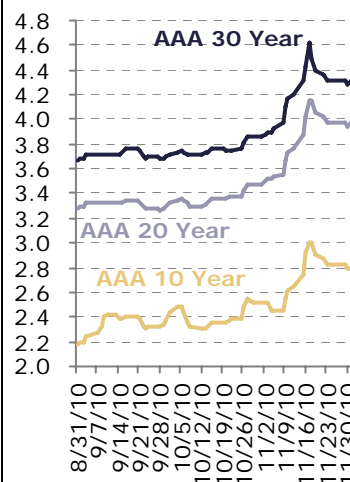
Historically, the three months from September through November have been a period of greater new municipal bond issuance than other times of the year. Most states have fiscal years which begin on July 1; after budgets have been passed, states and their municipal subdivisions assess their borrowing needs and come to market with new issues. This year, however, many states were late in passing their budgets, and this contributed to a delay in assessing those borrowing needs. New issuance was crowded into November. According to Bloomberg<sup>1</sup>, municipalities borrowed over \$55 billion in November alone, which was the largest amount borrowed in a single month since 2003. At the same time, municipal bond mutual funds experienced redemptions of \$5.4 billion<sup>1</sup>. As a result, fund managers were compelled to sell when supply was increasing, putting further downward pressure on bond prices.

Uncertainty about the future of the Build America Bond program may also have contributed to the weakness of the municipal market over this period. Build America Bonds (BABs) were established as part of the American Recovery and Reinvestment Act of 2009, and provide governmental issuers of taxable municipal bonds with a 35% interest rate subsidy from the Federal government throughout the life of the bonds. The program was created to provide another source of funding to municipal issuers in addition to the traditional tax-exempt market. It was very successful, and for much of 2009 and 2010, many issuers decided to take advantage of the Federal subsidy and issue taxable bonds instead of tax-exempt bonds. That program is set to expire on December 31, 2010. At the time of this bulletin, it is still not known if BABs will be terminated or extended for another year, and if they are extended, what the subsidy rate will be. As a result, the recent cheapening of the tax-exempt municipal market may also reflect the extra yield investors demand to compensate them for the possibility that the BABs program will terminate, and traditional tax-exempt supply will continue to build.

The sharp sell-off in municipals illustrated one of the drawbacks of municipal bond ETFs (Exchange-Traded Funds). ETFs contain aspects of both closed and open-end mutual funds. Like closed-end funds, ETFs trade throughout the day. But like open-end funds, the ETF manager stands ready to issue new shares when demand increases and purchase shares when there are net redemptions. Theoretically, this keeps the ETF trading close to the fund's underlying NAV.

However, the recent performance of municipal ETFs serves as a reminder that theory and practice can diverge. The municipal market is less liquid than stocks or Treasuries and, therefore, underlying municipal bonds trade less frequently while the related ETFs trade instantaneously. In the recent sell-off, the share prices of municipal ETFs fell more quickly than the prices of the underlying

### Municipal Yields



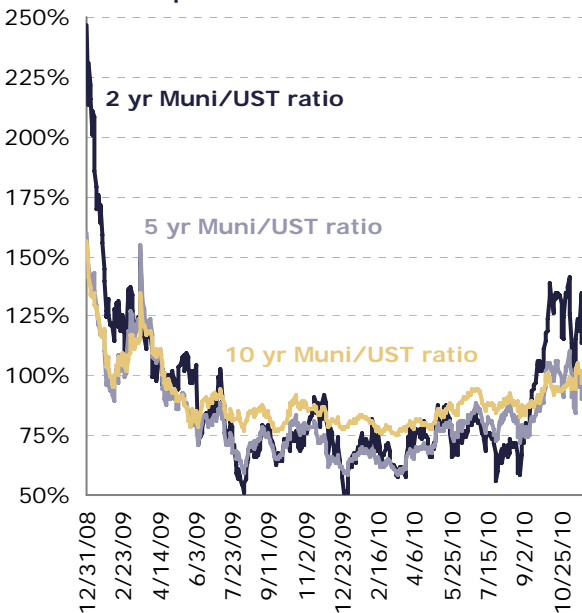
<sup>1</sup>Source: McGrail, Brendan and Harris, Alexandra. "Tax-Exempts Suffer Biggest Monthly Drop This Year: Muni Credit." Bloomberg Businessweek 1 Dec 2010. <  
<http://www.businessweek.com/news/2010-12-01/tax-exempts-suffer-biggest-monthly-drop-this-year-muni-credit.html>>

bonds, resulting in ETFs which were trading at a discount to those bonds. The liquidity mismatch between the characteristics of the municipal bond market and an investment vehicle that trades on a major stock exchange was the root cause of this disparity. Though the gap closed within a day or two, the conclusion is that municipal ETFs have more in common with closed-end funds than ETFs built around more liquid securities.

We are keenly aware of the challenges that many issuers currently face; however, we believe this sell-off is technical in nature rather than a result of any meaningful deterioration in the underlying credit worthiness of the municipal market. This is not to say that state and local governments are not financially challenged right now. For most states, income and sales tax receipts during the recession are below what they were in the middle of the last decade (although these collections have now risen for the third quarter in a row). During this time, state and local governments have had to make difficult decisions. However, even in challenging times, there are issuers which are well managed and better positioned. These include general obligation and revenue bond issuers who have been proactive with cost-cutting measures, have maintained sizeable reserve funds, are cautious about revenue projections and about taking on new expenses, and can comfortably service their debts. It is Samson's task to identify the municipal issuers with the strongest credit quality, which includes an analysis of their financial and economic condition and of the security that is pledged to the bondholders. These are the issuers that we seek to identify in our credit research process. We are confident that the bonds in our clients' portfolios will pay principal and coupon interest as scheduled.

As a result of the increase in municipal bond yields in the longer maturities, the ratio of municipal yields to yields of comparable maturity Treasuries has risen to high levels by historic standards, and the municipal yield curve has steepened further (see the following charts). We view the current weakness as an opportunity to modestly increase positions in the longer end of our target barbell portfolio structure, the 7-12 year maturities.

**AAA G.O Municipals / UST Ratios**



**AAA G.O Municipal Curve Steepness**



In conclusion, we view the current market weakness as primarily technical in nature, due to a pronounced, but temporary, increase in supply. We do not believe it is the result of material changes in underlying fundamentals.

Joseph A. Abraham

Principal

December 3, 2010

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