The Case for Tax Exempt Infrastructure Bonds

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The fundamentals of infrastructure revenue bonds have shown to be resilient over market cycles and may improve during periods of inflation and economic growth.

OVERVIEW: Why Consider an Investment with Infrastructure Bond Exposure?

For over a century, federally tax exempt municipal bonds have been the main source of funding to finance infrastructure projects – such as roads, schools, utility plants, bridges, hospitals and airports – that are essential to our everyday living. As an investment option, "infrastructure bonds" have the potential to provide investors with a high level of federally tax free regular income that is derived from revenues related to these essential long-term projects and services. Municipal infrastructure bonds also have a demonstrated record of credit stability over economic cycles. At Standish we appreciate the value of infrastructure bonds and believe investors should consider their potential benefits within their municipal investment strategy.

MUNICIPAL REVENUE BONDS FINANCE ESSENTIAL INFRASTRUCTURE PROJECTS

Municipal infrastructure financings most commonly come to market in the form of revenue bond issuance. Unlike General Obligation bonds (GOs), which are bonds backed by the issuing jurisdiction's general credit and taxing power, revenue bonds are secured by pledges of dedicated resources (or in certain cases, taxes related to the particular project(s) being financed) that are distinct and separate from general government operations. Revenue bond issuers typically have operations that are more insulated from the political pressures to which state governments are subject. In addition, most revenue bond issuers have natural monopolistic characteristics: for example, most water and utility enterprises face little competition for their services and often are the exclusive provider. Infrastructure revenue bonds usually are issued to build long-lived assets as opposed to financing operations, and historically, many have generated stable and somewhat predictable revenues. Because these revenue bond issuers provide essential services, the revenues from many of these issuers have historically been more resilient during weaker economic conditions relative to tax revenues that go to support state and local GOs, including during the recent financial crisis of 2008-09. (Figure 1.)

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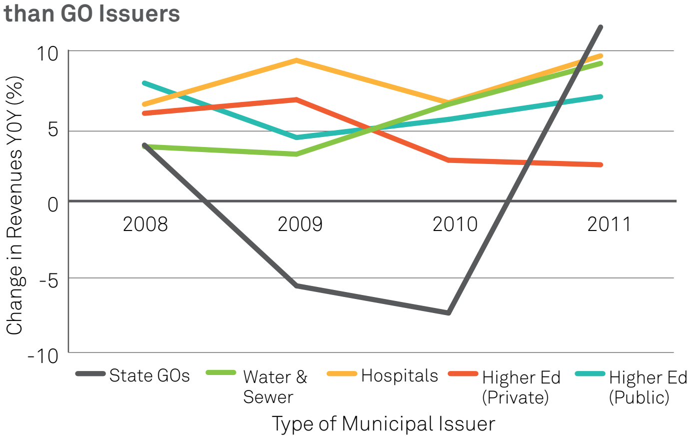
FIGURE 1 Many Revenue Bond Issuers Have Demonstrated More Stable Revenue Streams Since the Financial Crisis than GO Issuers



Source: Moodys, Standish. Based on annual year-over-year percent changes in median state GO revenues versus median revenues for water and sewer systems, hospitals, and public and private higher education facilities for fiscal year (FY) periods beginning 2007 through 2011. There is no guarantee that these trends will continue in the future. **GOs are generally viewed as having higher creditworthiness relative to revenue bonds due to the GO issuers' pledge of their full faith, credit and taxing power, all other factors being equal.** Municipality revenue flows will vary year over year and may be affected by various economic and fiscal factors.

REVENUE BONDS – INCLUDING INFRASTRUCTURE BONDS – MAY PROVIDE CREDIT STABILITY

From a credit perspective, it is worth noting that GOs are generally viewed as having higher creditworthiness relative to revenue bonds due to the GO issuers' pledge of their full faith, credit and taxing power, all other factors being equal. However, we believe the downside risk of essential-purpose revenue bonds may be less impacted in weaker economic periods than GOs (since the public tends to rely on the services the former provide), while also exhibiting the ability to benefit from exposure to economic growth as usage increases along with economic gains. For example, during inflationary periods, an essential-purpose borrowers' (i.e., water systems, airports, hospitals, etc.) top-line revenue growth potential can outpace fixed costs, such as debt service resulting in capital surpluses. This factor may offer a type of defense mechanism during inflationary periods not necessarily seen with GOs. Financial and credit disclosures for infrastructure projects are also often more timely than those of state and local governments and can oftentimes provide a clearer picture of financial strengths and trends. Finally, since infrastructure bonds are generally used to finance "brick and mortar" assets, which support the bond's intrinsic value over time, the useful life of their financed assets tends to match the life of the bonds.

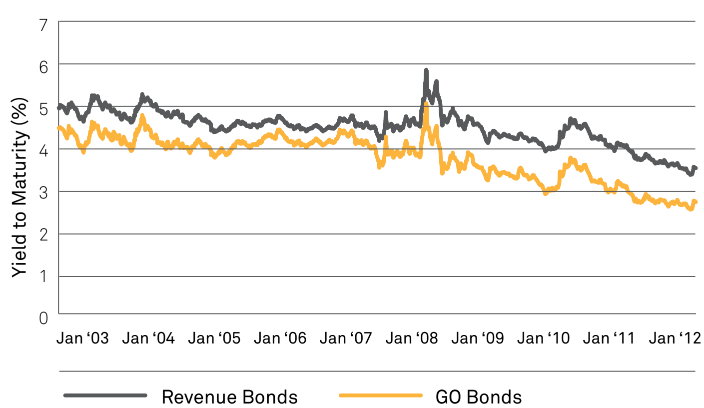
MUNICIPAL REVENUE BONDS MAY OFFER HIGHER YIELD POTENTIAL

Municipal revenue bonds have the potential to offer both a high level of absolute and relative after-tax current income potential versus comparably rated GOs of equal maturity, as shown in Figure 2. There are several factors that we believe support this view. First, municipal revenue bond credit analysis is not as straightforward as GOs' analysis and deters direct retail investment, which generally prefers the full faith and credit pledge of general obligation bonds. For example, revenue bond credit analysis requires evaluation of legal covenants, which is not typically required for GOs, and balance sheet analysis can be more complicated (yet, more important) for revenue bonds. Since direct retail buyers represent approximately 47.1% of municipal market share,[1] supply/demand ramifications help explain to some extent the higher yields found among infrastructure bonds.

Second, retail investors may prefer GOs because of the familiarity of these issuers since they are issued by home cities and states. Third, with the decline in the bond insurance market beginning in 2008, the yield difference between revenue bonds (that historically would have had the 'monoline' insurance enhancement[2]) and GOs has widened further, as shown in the Figure at left. This is because the lack of monoline insurance removed a "credit enhancement" on the bond. We underscore that the creditworthiness of a

FIGURE 2 Historically, Revenue Bonds Have Achieved Higher Yields versus GOs

January 2003-December 2012



Source: Bank of America, Standish. **Past performance is no guarantee of future results.** Yields fluctuate. Comparisons of different time periods may produce different results. The BofA Merrill Lynch U.S. Municipal Securities Index (BofA Index) tracks the performance of U.S. dollar-denominated investment grade tax-exempt debt publicly issued by U.S. states and territories, and their political subdivisions, in the U.S. domestic market. Qualifying securities must have at least one year remaining term to final maturity, a fixed coupon schedule and an investment-grade rating (based on an average of Moody's, S&P and Fitch). Each of the A-Rated Revenue Bond and A-Rated GO Bond sectors shown above are subsets of the BofA Index. Yield to Maturity (conventional terms) reflects the bond's cash flows to maturity discounted using a yield based on the same coupon frequency of the bond. Investors cannot invest directly in any index. Actual results will vary.

1. Source: Federal Reserve, *Flow of Funds Accounts*, Fourth Quarter 2012.
2. Refers to "Letters of Credit" from private issuers intended to enhance the credit quality of the issue. The value of the letter of credit is tied to the insurance company's claims-paying ability.

GO is considered to be higher than that of a revenue bond, all things being equal — a factor that does impact yield spreads between revenue bonds and GOs over time.

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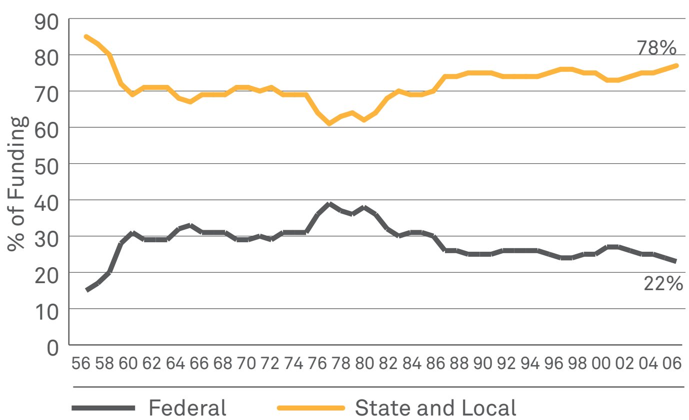
As we look toward the future with a trend of aging infrastructure approaching the end of its life cycle, and the strains of a growing population fueling the need for new construction, state and local governments across the country will be keenly focused on sustaining the usefulness and safety of U.S. infrastructure. Most state and local governments issue debt in various sectors to finance infrastructure, and can range from the largest U.S. metropolitan areas to small towns, providing for a very diverse universe of investible opportunities. According to data from the Congressional Budget Office, since the 1950s about three-quarters of infrastructure funding has come from state and local governments – as opposed to federal and/or private investments (Figure 3). A large reason for this trend is the federal tax-exempt provisions of municipal bonds that serve as an effective subsidy to encourage brick and mortar infrastructure development. Additionally, lower issuance expenses as a result of today's low interest rate environment can provide financial relief to government issuers and defend against higher income taxes, or help free up funds for revenue authorities to deliver higher levels of services.

FIGURE 3 State and Local Governments Have Funded the Majority of Infrastructure Projects



Source: Congressional Budget Office, November 2010 Study. Data for more recent periods not available as of the date of this report.

HOW CREDIT RESEARCH EXPERTISE IS IMPORTANT TO SUPPORT MUNICIPAL INFRASTRUCTURE INVESTING

The fundamentals of infrastructure revenue bonds have shown to be resilient over market cycles and may improve during periods of inflation and economic growth. Dedicated resources pledged to repay bondholders also provide investors with a layer of credit protection from the political challenges facing many municipal governments. We believe these factors are supportive of municipal infrastructure bond exposure, whether as a focused tax-exempt investment or within a balanced tax-exempt portfolio composed of both GOs and revenue bonds.

Access to credit information and market intelligence is an important consideration when pursuing investment exposure to infrastructure bonds. Our internal analyses of financial performance (operating margins) and position (liquidity and debt burden), operating trends (utilization trends) and legal covenants allow us to generate internal credit opinions which often differ from the rating agency ratings, and give our portfolio managers and traders the necessary insights to assess which bonds may offer good relative value, which issues may be overvalued, as well as which credits are deteriorating and should be avoided outright.

Our credit team analyzes municipal infrastructure revenue bonds across the entire yield curve and credit spectrum. In particular within the revenue bond sector, each issuer can be highly specialized and requires a significant level of expertise. Municipal bond credit disclosure can be unpredictable and more opaque than what is typical for corporate bond and equity issuers. In addition to financial statements, demographic and economic analysis, our professional analysts often will conduct site visits to conduct due diligence on the projects that are issuing debt and meet with management.

In closing, we at Standish believe very strongly in the high credit quality of infrastructure revenue bonds, and are of the opinion that they can provide a distinctive investment opportunity.

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Main Risks

Bond funds are subject generally to interest rate, credit, liquidity and market risks, among other factors, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes, and rate increases can produce price declines.

High yield bonds are subject to increased credit risk and are considered speculative in terms of the issuer's perceived ability to continue making interest payments on a timely basis and to repay principal upon maturity.

Infrastructure sectors and projects may be subject to a variety of factors that may adversely affect their development, including (but not limited to): high amounts of leverage and high interest costs in connection with capital construction and improvement programs; difficulty in raising capital in adequate amounts on reasonable terms in periods of high inflation and unsettled capital markets; and costs associated with compliance with and changes in environmental and other regulations.

Income from municipal bonds in general may be subject to state and local taxes. Some income may be subject to the federal alternative minimum tax (AMT) for certain investors. Capital gains, if any, are taxable.

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