

PRESIDENT'S LETTER
FEBRUARY 2010

The 2009 municipal bond market was much kinder and gentler than the 2008 version and, as a result, some investors are falling back into the pre-2008 malaise: making uninformed or spur-of-the-moment investment decisions often based upon inadequate information.

Recently a client asked, “what did you learn about the bond market during the financial crisis?” I prefaced my response by saying, “before the crisis ever happened we already believed in our investment philosophy; the crisis indelibly reinforced those beliefs. Now, we **know** our approach is correct.”

The first section of this letter addresses, in part, our client’s question. The balance of my letter focuses on the Build America Bonds Story.

A few of my 2008/2009 financial crisis “takeaways”:

1. Understand your bond investment because underlying credit quality, purpose and structure matter. Always start the bond investment process with credit analysis. Hands on credit analysis is best. An outside rating agency credit assessment is helpful in determining credit quality, but is only one credit metric to consider. What is the purpose of the debt issued? What party are you lending to and how does the obligor intend to pay you back? Are your funds close to the obligor or are they 2, 3 contra parties (auction rate securities) removed? If you are unable to figure any of this out, the investment probably should be avoided.

2. I am convinced more than ever that the “perfect” bond market hedge does not exist. Many, many investors lost money over the last 18 months on “hedged” bond investments and swaps. Some would have seen their “hedged” investments wiped out entirely had not the government rescued certain financial institutions. When making an investment in the bond market, understand there is risk and be prepared to lose money occasionally. If you cannot reconcile with that possibility, you should not invest in the bond market.

3. Complex derivatives equal volatility. There is nothing wrong with this dynamic. In fact, the volatility dynamic often works wonderfully in your favor when the market is going your way. Returns can be significant. However, when the market goes against you, this volatility often creates significant loss.

4. Outsourcing bond portfolio management, bond credit analysis and regulatory oversight and control responsibilities often proves problematical for companies. At Bernardi Securities Inc., we have in house vertical integration of these services, which provides our clients significant advantage in terms of flexibility, market efficiency and operational integrity. These services are at the core of our business model and our near complete control over them is the primary factor responsible for our clients’ success over the years.

5. The municipal bond market has been amazingly resilient despite many setbacks over the past 18 months. The marketplace has served investors and state and local governments for over 100 years helping to raise capital for public projects. It has not always been easy or the most efficient process, but, all in all, the system has worked remarkably well at allocating capital for local projects at reasonable borrowing costs.

The 2009 municipal bond market storyline featured three major themes:

1. Sharply higher bond prices
2. Continued stress on issuer credit quality in many sectors
3. Build America Bonds

We have discussed the first two themes in detail in recent publications so today I will focus on the Build America Bonds (BABS) story.

The BABS program was part of the American Recovery and Reinvestment Act of 2009 and its purpose was to temporarily (calendar year 2009 and 2010) assist municipalities access the credit markets and spur local capital projects in order to create jobs. Certain issuers had difficulty accessing the credit market in the latter half of 2008 and early part of 2009. Additionally, many issuers that did access the marketplace paid higher interest rates than they had become accustomed to paying during the first part of the decade. Job creation is a noble goal, of course. All of these factors led to the creation of the two-year BABS program.

The BABS experiment has transformed the municipal bond marketplace. If success is measured by usage, then the program's success has been remarkable. Approximately \$64 billion in new bonds have been issued since the program's inception in March of 2009 as States and municipalities across the nation have borrowed under the program. The program pays them a 35% (45% for super BABs) federal subsidy on the interest cost of taxable capital projects bonds they issue in 2009 and 2010. Faced with the option of issuing traditional, non-taxable bonds for the same capital projects or the federally subsidized taxable bonds, responsible state and municipal officials across the country are opting for the BABS program when it is economically advantageous for them to do so. The program gives municipal bond issuers a powerful new tool to raise money because it expands issuance option and the investor base.

Recently, many elected officials have indicated support to extend and expand the program. President Obama has included provisions in the administration's fiscal 2011 budget proposal making the BABS program permanent, expanding the program's permitted uses and reducing the federal subsidy from 35% to 28%. I expect the proposed expansion will prevail in some form.

I am worried, however, of the potential negative, long-term implications of the BAB program for both municipal governments and all taxpayers. Here's why:

1. Significant program cost to taxpayers – The Congressional Budget Office (CBO) January 2010 report estimates the BABS program will cost the Treasury \$26 billion in ADDITIONAL outlays over the 2010-2019 time period. This significant cost overrun has occurred in just ten months and does not include any additional costs that will result from extending and expanding the program as currently proposed. In an earlier 2009 report, the CBO estimated the BABS program tax credits would cost taxpayers approximately \$1 billion a year from fiscal 2012 through 2019. The current CBO estimate for the program is over \$3 billion a year through 2019. **In short, the current BABS program is over initial budget estimates by a factor of three in 10 months. Keep in mind these estimates do not include program administrative and compliance costs either at the local or federal level.**

How much additional cost can we expect from an expanded program? Who knows? But, the cost to taxpayers will be significantly greater than the basis on which the program was introduced in early 2009.

2. Why pay less, when you can pay more? – At the macro economic level, the need for the program today makes much less economic sense than it did one year ago. Let's remember the program was initiated to assist municipal governments access the market and help lower borrowing costs for those who paid too high a price during the height of the financial crisis in 2008 and 2009. This market dynamic has changed dramatically (in part, because of the BABS program) and, today, most municipal governments enjoy wide access to the municipal market and historically low borrowing costs. Only the credit challenged municipalities that perennially run deficits appear to be experiencing elevated borrowing costs. In short, a relatively efficient and accessible municipal bond marketplace for most issuers has returned now that the investing world has calmed and the panic that ensued from the 2008 financial crisis has passed.

If success is measured by usage, then the program's success has been remarkable. Approximately \$60 billion in new bonds have been issued since the program's inception in March of 2009.

Therefore, why extend and expand the BABS program? Why offer the program to all municipalities regardless of financial strength? The program, as it is currently structured, allows local issuers to borrow at lower interest rates than its economic fundamentals would otherwise allow and is paid for by taxpayers across the nation. Is this behavior we want to encourage? Perhaps, the program should be extended only to the weakest municipal credits with some fiscal strings attached. Should taxpayers across the nation subsidize 35% of, let's say a 6% taxable bond issue to finance the construction of a park district facility half way across the country for a solvent, well run district that could finance the project on its own at a 4.50% non taxable rate relying on local tax receipts or revenues to pay off the loan? Should taxpayers across the country subsidize a poorly run issuers finances and help it defer the tough economic decisions it should resolve? Why pay 6% at the national level rather than 4.50% at the local level?

Financial independence and the ability of state and local governments to raise capital independent of the federal government is critical to maintaining this balance.

3. The BABS program serves to reduce a tax break benefiting the wealthy? - The federal income tax exemption enjoyed by municipal bond investors has been in the gun sights of many in Congress for years. The BABS program will help reduce this subsidy to the rich, say certain proponents of the program, by reducing the supply of non-taxable bonds available for investment forcing some investors into buying taxable BAB municipal bonds instead. **These taxable investments would generate tax receipts for the Treasury. In fact, the Treasury recently stated it would spend \$2.9 billion in 2010 on the program while recouping \$1.3 billion in taxes paid on interest earned by BABS investors during the same period for a net program cost of \$1.6 billion.** The figures, I assume, are correct. But to refer to a "net" cost figure is somewhat misleading because the "net program cost" analysis has a serious flaw, I believe.

At Bernardi Securities, Inc., we have not seen the investor crossover assumed in the analysis. Investors in high tax brackets are not shifting their investment dollars from non-taxable municipal issues into the taxable municipal BABS issues. High income tax bracket investors continue to invest their capital in the remaining \$2.5 trillion pool of outstanding non-taxable municipal bonds. In the years ahead, we expect high tax bracket investors will continue to invest their capital in the remaining substantial supply of outstanding non taxable issues as well as new non taxable issues that will come to market. There is no doubt the program is generating tax receipts for the Treasury, but the receipts, I suspect, are coming mostly from investors who in the past invested in other types of taxable bonds. The fact is, the significant investors in the BABS issues to date have been foreigners, pensions, other types of retirement accounts and low income tax bracket taxpayers. For the most part, these are investors who pay either no federal income tax or pay taxes at the lower end of the spectrum. One thing is for certain: the jury is still out on this one and it will be years before we have accurate data on the issue. My guess is that what we are seeing on a small scale at Bernardi Securities, Inc., will prove to be consistent with the wider view.

4. Maintaining an historic balance between federal power and states' powers is critical in my view. **Financial independence and the ability of state and local governments to raise capital independent of the federal government is critical to maintaining this balance.** The BAB program may well threaten all of this.

The U.S. Supreme Court ruled in 1895 that the federal government had no power under the U.S. Constitution to tax interest on municipal bonds (Pollock vs. Farmer's Loan & Trust Company, 157 U.S. 429) because such a tax violated the doctrine of intergovernmental tax immunity ("the power to tax involves the power to destroy", Justice John Marshall, 1819). This Court decision laid the foundation for the development of the tax-exempt municipal bond market. Following the enactment a federal income tax in 1913, the federal government has indirectly aided municipal governments finance capital projects by exempting interest income on state and local government debt from federal income tax. Over the decades, the tax-exempt municipal bond market has developed into a sophisticated marketplace; a market that has provided capital for thousands of municipal projects. In short, the tax-exempt municipal bond market has helped state and local governments raise capital for local projects independent of the federal government and its often fickle agenda. This ability to raise capital has played a significant role in maintaining the balance between federalism and states' powers, a central tenet on which this nation is founded.

In 1988, the Supreme Court ruled (South Carolina vs. Baker) Congress could tax interest income on municipal bonds if it so desired on the basis that tax exemption is not protected under the Constitution. There have been occasional attempts to

remove the tax-exempt status of municipal bonds over the years, but none has been successful to date. The BABS program does not threaten the exemption directly, but certainly challenges it an indirect manner.

After all, if Congress were to increase the federal subsidy on BABS issues from the current 35% to, say 80%, would it not, in effect spell the end of the tax exempt bond market over time as virtually all municipal issuers would opt for issuing the taxable debt in order to receive the generous federal handout? Today this seems farfetched, but with every diminution of the tax-exempt bond market, the financial independence of state and local governments is also diminished.

Let me be clear that I do not believe BAB proponents have hidden motives. I agree with and applaud the program's initial intent and its resounding success to date.

But things change as do the powers in Washington and I believe it is very important all of us at the local level understand the broader implications of the current program and the proposed expanded version. Specifically, the current proposal to expand the BAB program includes allowing the federally subsidized bonds to be issued to pay for municipal issuers refinancings and operating expenses.

These proposed expanded uses of the BABS program strike me as inconsistent with the program's original intent. Why the change? Will the federal government require these subsidized funds be spent in a specific manner to promote its agenda once municipalities are hooked on the federal subsidy? Oregon's Senator Ron Wyden, who is a key sponsor of the BABS legislation, has stated, "I would like to see different flavors of BAB's created...that would allow us to adjust the subsidy and give, for example, transportation infrastructure investment a larger subsidy than other types of projects because transportation projects typically create more jobs and other public benefits."

Should we create a system where taxpayers across the nation are subsidizing a municipal issuer's operating capital?

Years ago (1978), I wrote a paper on the "Municipal Finance System in Italy". I was junior in college, studying in Florence, Italy and had the opportunity to interview city officials, local politicians and University of Florence finance professors all of whom helped me in my research. At that time, the saying, "all roads lead to Rome" applied to the way in which Italian municipal governments received funding for local projects. There was a tedious, red tape laden, seemingly never ending bureaucratic process that local governments had to endure in order to receive funding from the central government in Rome for the most basic municipal projects: school construction, street improvements, water and sewer system improvements.

To a person, all of the people I interviewed were frustrated by the inefficiency of the financing process and the lack of independence that existed at the local level. Local governments enjoyed very little independence from Rome because Rome controlled the purse strings of the local governments. It was an illuminating lesson to learn first hand.

It is a lesson I have never forgotten.

Ronald P. Bernardi
President and CEO
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