

Municipal Bond "Reversion Trade"

December 2008 Update

The Story

Introduction

As you might know, the fixed income market has experienced significant volatility for much of the past year. As the global financial system continues to show signs of strain, many investors have reevaluated their risk tolerance, leading to a widespread repricing of risk. This phenomenon has affected nearly every corner of the fixed income universe, municipal bonds being no exception. For various reasons, municipal bond prices have come under considerable pressure in recent months. **In our view, the dislocations experienced in the municipal bond market have created a particularly attractive buying opportunity for value-minded fixed income investors.**

Municipal bonds are considered the second safest fixed income category following securities issued by the federal government. Within these bonds, general obligation bonds are considered the safest, since they are usually backed by the full faith, credit and taxing powers of the local government that issued the bonds. The bonds tend to yield less than US Government Treasuries because interest payments from municipals are exempt from federal income taxes. The historical average yield on a 10-year general obligation bond is 80% that of a 10-year Treasury bond (aka. municipal/ treasury ratio).

Municipal bonds are proving that the liquidity credit crunch has left no sector untarnished which is now presenting investors with an intriguing opportunity. Municipal bonds are now yielding more than Treasuries. In addition, after the tax benefit, the yield difference is profound.

	Municipal Yield "AA" Rated G.O.	Treasury Yield	Municipal/ Treasury Ratio	Municipal Tax Equivalent Yield
1 Year	1.16%	0.83%	139.76%	1.78%
2 Year	2.15%	1.00%	216.08%	3.31%
3 Year	2.40%	1.22%	197.53%	3.69%
4 Year	2.73%	1.34%	203.13%	4.20%
5 Year	2.94%	1.95%	150.85%	4.52%
10 Year	3.93%	3.45%	113.91%	6.04%
15 Year	4.69%	4.50%	104.22%	7.21%
20 Year	5.02%	4.34%	115.67%	7.72%
25 Year	5.23%	4.28%	122.20%	8.04%
30 Year	5.33%	4.01%	132.92%	8.20%

Source: Bloomberg LLP. & Municipal Market Data as of 11/21/2008

The following trading strategy is currently utilized by our discretionary management accounts. It should not be indicative of the success of future strategies. This document is for illustrative purposes only. LOM is licensed to conduct investment business by the Bermuda Monetary Authority.

This stunning turnaround in valuations of these bonds stem from 4 main factors:

1. **Bond Insurance Companies on Watch:** The insurance companies that guarantee many of the municipal bonds have had their own credit worthiness tested. This has caused investors to shy away from insured bonds. While we understand the trepidation, the bonds we are recommending are those of strong local U.S. municipalities. The solvency of these states and cities is not a current concern. Hence, we view the insurance as a free option.
2. **Illiquid ARC Market:** The municipal Auction Rate Certificate ("ARC") market has seen many auctions fail in the past six months. Although this does create a concern in this specific market for ARC's, it should not deter an investment in fixed rate, short- to intermediate-maturity municipal bonds. ARC's have long-dated final maturities with coupon rates that are reset based on a participant depended auction. If a holder wants to sell a bond they must elect to do so at a scheduled auction. In the past month, many of these auctions have not had participants. These failures are liquidity-based and have nothing to do with the underlying credit worthiness of the municipality, but rather the fact that typical buyers are reluctant to "get stuck" with the bond until maturity.
3. **Deleveraging:** Hedge funds have been large sellers of municipal bonds in order to reduce leverage and to cover losses created as other strategies have failed. As a result, this has created more sellers than buyers in the municipal market and has therefore placed downward pressure on prices. Once the deleveraging stops, this will correct itself.
4. **Broker-Dealers in Jeopardy:** Major broker-dealers in the past had virtually unlimited ability to buy bonds for inventory. Many of these firms no longer exist (i.e. Bear Stearns, Lehman Brothers) or are impaired in terms of using their balance sheet to carry inventory. We feel that this will correct itself once the crisis subsides and balance sheets become healthier.

We feel that all of these issues will be temporary and firmly believe there will be a "Reversion to the Mean". We also believe that the municipal market will normalize for the following reasons:

1. Municipal bonds deliver dependable returns, losing money only once in the past 10 years— a 2.1% decline in 1999.
2. If President-elect Obama raises taxes, municipal bonds will become even more attractive because of their federal tax -exempt status.
3. The municipal market will provide valuable protection to rising treasury rates that will accompany an eventual economic recovery. When the recovery becomes imminent, interest rates will rise and the credit crunch will subside, making other asset classes (municipals first) more attractive. When this happens the municipal rates will naturally rise much less than comparable treasuries.
4. On the flip side, if the economy continues to stagnate, the treasury market will eventually become completely unattractive (where short treasury bills trade around 0.00%). As this happens investors will naturally shift to the next safest asset class, municipal bonds.

