



STANDISH

Tax Sensitive Fixed Income



## Monthly Municipal Market Update

### Market Commentary

*“Investors need to consider offsetting benefits that crossing state lines can deliver... these include lower portfolio volatility, improved credit diversification, better liquidity...”*

#### Geographic Diversification: The Case for “Crossing State Lines”

The financial incentive to hold in-state municipal bonds, which are typically exempt from state or local taxation for individuals domiciled in that region, can be overshadowed by the many benefits of broad geographic diversification.

In most states, owning in-state municipal bonds may provide a compelling tax advantage. As an example, a California resident (10.3% state tax) requires approximately 0.25% extra yield on a comparable out-of-state 10-year bond to offset the in-state tax advantage. The tax advantage is most generous for the highest tax states. The economics however, are only one side of the equation, and investors need to consider offsetting benefits that “crossing state lines” can deliver.

**Diversification** –The market can impose discounts on a purely state specific basis. External forces can impact valuations, due to regional economic coincidence, in-state political dynamics, or even media-driven reporting from sources with little understanding of municipal credit fundamentals. A “contagion effect” amongst municipal bond investors (whether rational or not) can be mitigated by broadening geographic exposure across portfolio holdings to diversify issuer and credit risk.

**Supply** – Most states represent about 1-2% of the national municipal market. Higher tax states with robust demand but limited supply (e.g. Connecticut or Oregon) may find in-state bond prices expensive (strong retail investor demand and light supply) relative to bonds with low or no income tax. Investors can take advantage of these supply/demand inefficiencies by considering out-of-state bonds where issuance is heavy and/or tax rates are low. In many cases, excess yield can negate the tax differential between in and out-of-state bonds.

**Liquidity** – Better liquidity may be found holding bonds issued by the largest and most frequently traded issuers. More populous states tend to issuer the larger deals, but may not offer local tax exemption.

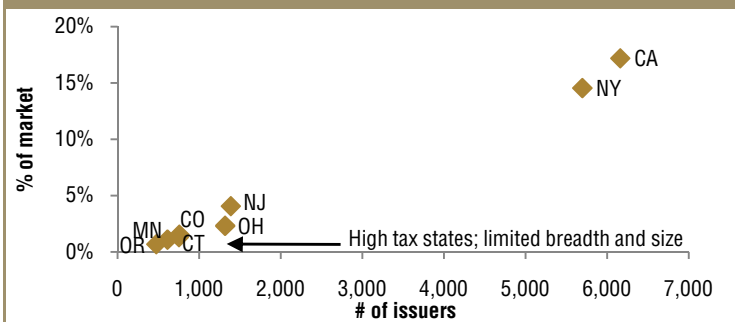
**So when does it make sense to have a high allocation to in-state bonds?** For populous states with high taxes like California and New York, investors’ should consider a relatively high in-state bond allocation. The higher exposure compared to other smaller and lower tax states is warranted due to the large size and overall breadth of issuers and sectors available to investors (CA and NY bonds represented 14% and 9% of total 2010 issuance respectively). In-state exposure is even more important for investors subject to the Alternative Minimum Tax (AMT), when state taxes are not deductible on a federal basis.

In summary, we believe that any bond yield deficiency after considering state taxes should be weighed with the potential benefits of “crossing state lines”. These include lower portfolio volatility, improved credit diversification, better liquidity and potentially higher after-tax yield and total return.

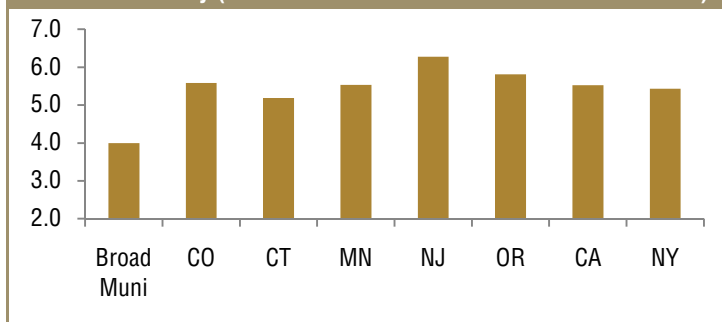
*Daniel Marques, CFA, Portfolio Manager*

### Charts of the Month

New York and California Markets Offer Breadth and Size



Portfolio Volatility (Annualized Standard Deviation Total Return)



Source: Standish, Barclays Municipal Index as of April 30, 2011

Source: Standish, Barclays Capital, \* Barclays Muni Index bonds, 5-15yr maturities, G.O. and Revenue sector, 8/1/05 to 4/30/11)

## Credit Observations

*“Debt service coverage is strong. Total motor vehicle license tax revenue in fiscal 2011 is expected to cover debt service as well as the senior obligations by approximately 4x.”*

### Credit in the Spotlight: Florida Port Financing Commission\*

The Florida Ports Financing Commission issued approximately \$268 million of State Transportation Trust Fund Revenue Bonds in May. The rating agencies rate the bonds Aa3/AA+/AA. Bonds are secured by motor vehicle licensing taxes appropriated annually from the state’s transportation trust fund. The appropriation must be made each year as required by state statute. Additionally the state covenants not to take any actions which would materially and adversely affect the rights of bondholders. The motor vehicle license tax revenue is allocated to service debt at a fixed amount of \$25 million per year and is made available after senior obligations such as pledges for state education, capital outlay and general transportation purposes have been made. We believe debt service coverage is strong. Total motor vehicle license tax revenue in fiscal 2011 is expected to cover debt service as well as the senior obligations by approximately 4x. We believe the motor vehicle tax revenue has shown to be resilient during the recession as the chart below indicates and note that the Florida legislature increased tax rates in fiscal 2010. The motor vehicle fee is assessed annually for the operation of motor vehicles, including auto, motorcycle, truck and recreational vehicles. The Florida Department of Transportation collects the fees and deposits the full allocation into an escrow for payment of debt service on July 1 of each fiscal year, ensuring that funds are available well in advance of the December 1 and June 1 debt service payment dates. Bond proceeds fund loans made by the Florida Port Commission to ports, and refinance or reimburse for state-approved capital projects.

\* Source: Florida Ports Financing Commission Refunding Revenue Bonds (State Transportation Trust Fund) Refunding Revenue Bonds Series 2011A and Series 2011B Preliminary Official Statement Dated May 2, 2011

*Jeffrey B. Burger, Senior Analyst*

### Other Credit Highlights: State Revenue Increases Continue\*\*

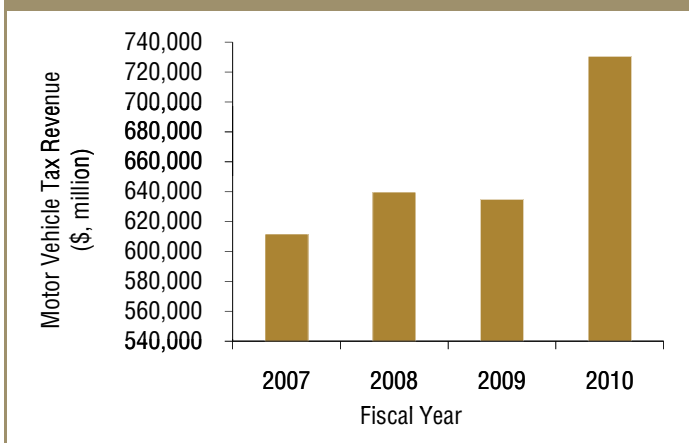
The Rockefeller Institute of Government reports that state tax revenues grew on a year over year basis for the 5th consecutive quarter. The increase of 9.1% for the quarter ending 3/31/11 exceeds the previous quarter’s yearly growth of 7.8% and is the highest since the quarter ending June 30, 2006. Strong growth in personal income taxes, which increased 12.4%, was the primary mover. The Great Lakes states showed the greatest increase (15.1%) followed by the Rocky Mountain states (11.7%) with Mid Atlantic the lowest (5.5%). New Hampshire was the only one of the 47 states included that showed a decline (-0.1%). Among major states California revenues increased 6.5%, Illinois, 22.2% (reflects tax rate increases), New York 6.2%, Florida 6.3% and Texas 7.8%. Several states heavily dependent on manufacturing such as Michigan, where revenues grew 14.6%, Wisconsin at 13.3% and Ohio, 11.6% performed very well.

\*\* Source: The Rockefeller Institute of Government

*David F. Belton, CFA, Head of Municipal Bond Research*

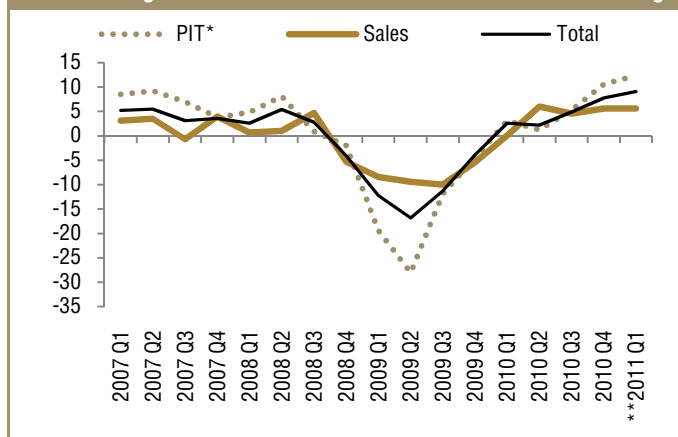
## Credit Charts of the Month

### Total Motor Vehicle License Tax Revenue



Source: Department of Highway Safety and Motor Vehicles Revenue Reports 2006-2010

### Percent Change in State Tax Collections vs. Same Quarter Year Ago



\* Personal Income Tax

\*\* 2011 Q1 data is preliminary

Source: The Nelson A. Rockefeller Institute of Government as of May 24, 2011

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