

Municipals: The State of Tax-Advantaged Investing

An RS Fixed Income Team
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Executive Summary

This paper provides a review of why municipal bonds matter, and how they can offer compelling investment potential for investors. We will discuss the benefits that municipal bonds can potentially offer investors, including interest income that generally is tax-free, and in some cases, may also be exempt from state and local taxes. Credit spreads are discussed, with comparisons made between municipals and treasury bonds. Municipal defaults and the associated municipal bankruptcy legislation is explored, followed by an examination of the outcomes of defaults and bankruptcies from an historical and current perspective. We also outline the history of municipal bonds, starting with their introduction in the 1800s; to the changes that took place across this market during 2009; to the introduction of Build America Bonds (BABs).

Introduction to the Municipal Bond Market

The municipal bond market has a long and rich history which has contributed to the building of America as we know it today. The municipal market has grown to about \$3 trillion¹ in size since its inception in the early 1800s.

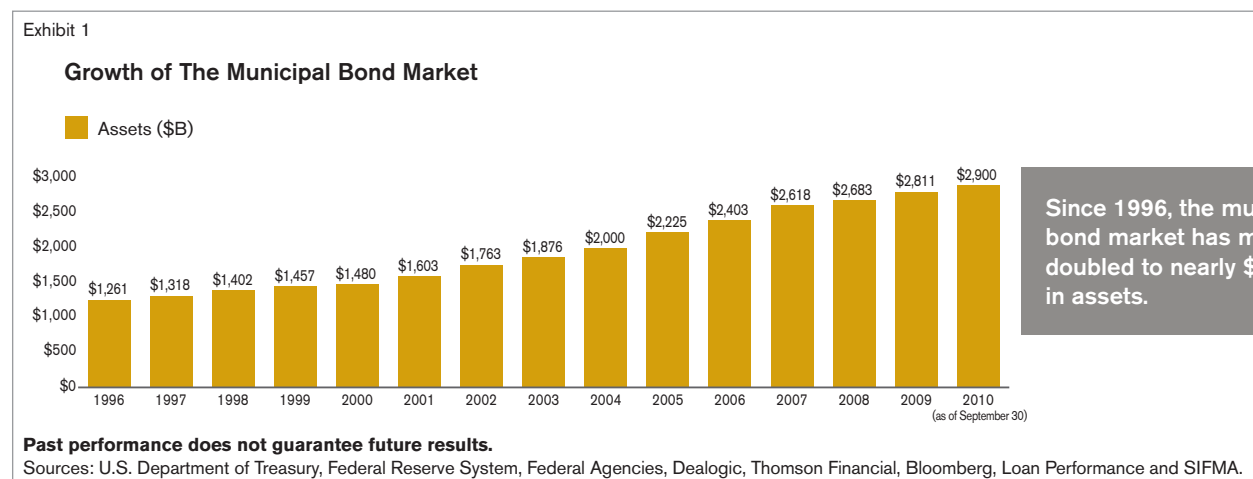
Typically, tax-exempt municipal bonds are exempt from federal income tax and can also be exempt

from state and city taxes. However, some municipal bonds may be subject to the federal Alternative Minimum Tax (AMT).

As Exhibit 1 details, the municipal asset class has continued to grow and become quite sizable over the years. This is reflected in the growth of tax-exempt municipal bond funds. In 2009, net inflows into municipal bond funds equalled \$69 billion.² In 2010, the municipal bond market continued to grow as issuing entities funded new needs: state and local governments issued \$274.2 billion in new bonds; of this \$151.9 billion was taxable. Over \$180 billion has been invested in taxable Build America Bonds, which would likely have gone into the tax-free market.³

Compelling Characteristics of Municipal Bonds

- Tax-free income
- Attractive historical total returns (see Exhibit 4)
- Low default rates—the 10-year average cumulative default rate for municipal bonds since 1970 was 0.09% versus 11.06% for corporate bonds as of year-end 2009 (Exhibit 5)
- Diversification*—Municipal bond returns are not highly correlated with equity markets. They also offer diversification for fixed-income portfolios invested in corporate and government bonds



*Diversification does not guarantee a profit nor protect against a loss.

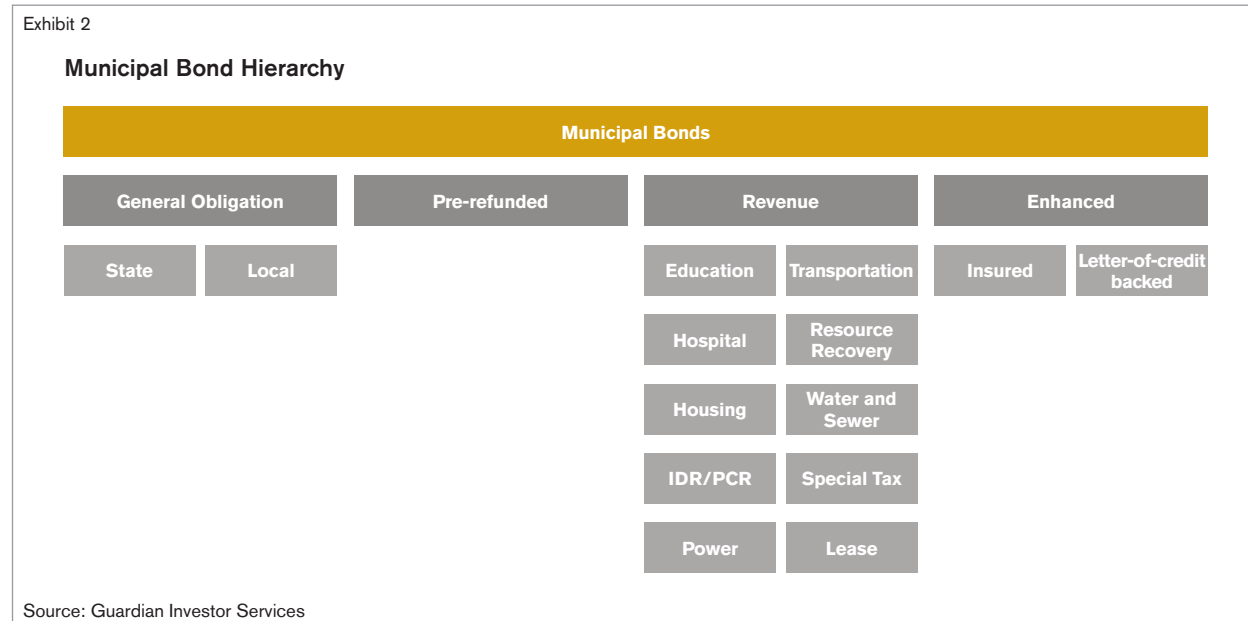
Municipal Bond Overview

The hierarchy of municipal bonds is detailed in Exhibit 2.

1. General Obligation (G.O.) bonds are issued by state and local governments and rely on sales tax, personal and corporate income taxes and property taxes. In times of recessions these revenues usually decline quickly; normally, an exception to this would be property taxes.
2. Pre-refunded bonds properly secured with U.S. Treasuries are amongst the highest credit quality of municipal bond securities.⁴
3. Revenue bonds are used to finance specific public works and are supported by the revenues of that project. Revenue bonds are issued for essential services such as water and sewer, transportation, and education to name but a few. Revenue bonds can also be issued for “non-essential” services such as convention centers and stadiums that could rely on the support of another entity to supplement the cash flows.
4. Bonds with enhanced credits are insured or letter-of-credit backed bonds.⁵

Until recently, many municipal issuers relied on monoline insurers⁶ to help market their bonds to both retail and institutional investors. Essentially, the bond issuer would buy insurance, for a fee, to insure their bonds. This insurance, in most cases, would enable the bond issuer to get a AAA rating from the rating agencies. As the investing public became more comfortable with insurance, underlying ratings (the actual ratings of the bond issuer) became less important, with more emphasis placed on the insurance. Towards the end of 2007, this proved to be a significant problem for the municipal market. As the monoline insurers had their ratings downgraded and the ratings started to slip below AA, municipal structures that required a contractual minimum of AA were liquidated. This in turn pushed more municipal supply into an already fragile market.

In May 2009, the American Recovery and Retirement Act of 2009 introduced another type of municipal bond. Build America Bonds, commonly referred to as BABs, were federally issued taxable bonds that could be issued only for specific purposes such as infrastructure needs, education and transportation, to name but a few. This program expired on January 1, 2011. BABs are discussed in more detail on page 5.



Measuring the Relative Value of Municipals

One way to measure municipal value is by dividing the hypothetical AAA municipal bond yield by the corresponding Treasury yield. For example, on September 30, 2010 the 30-year hypothetical AAA municipal yield was 3.70% and the corresponding current 30-year Treasury yield was 3.69%, resulting in a ratio of 100.39%.³ Historically, 30-year municipal bonds have been considered fairly valued at around an 89% ratio. The higher the ratio, the cheaper they are, whereas anything below 89% is considered expensive.³ This is important information when analyzing Exhibit 3 and one way to measure the value of municipal bonds.

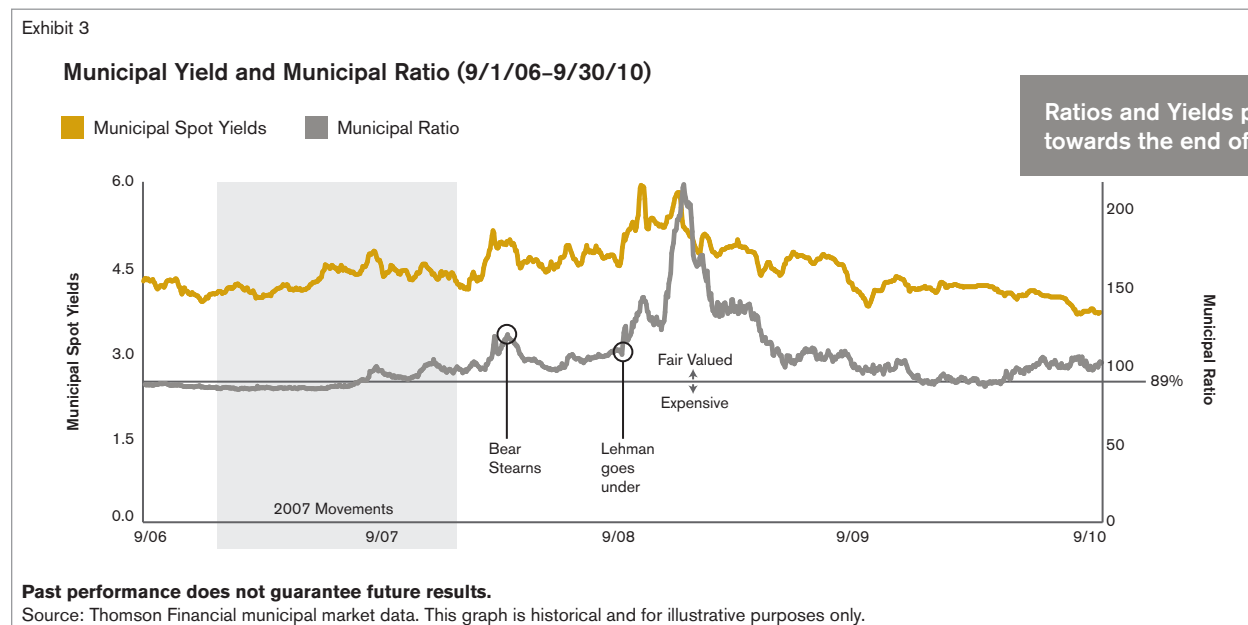
2007 Crisis

Exhibit 3 illustrates the recent history of spot yields and the value of those yields relative to Treasuries. In June 2007 municipals were expensive at a ratio of 85%. This was, for the most part, reflective of the leveraging (borrowing) that was going on in the municipal market, made possible by the monoline insurers. As insurers were downgraded in late 2007, their impact on the municipal market could not be ignored. Any counterparty that required a

minimum credit rating of AA to conduct business was in jeopardy if that minimum credit rating was not maintained. The municipal ratios increased as the participants in the market tried to deleverage in anticipation of further downgrades of the insurers.

Ratios spiked again in early 2008, as Bear Stearns, a major municipal participant, was bought by J. P. Morgan. They spiked again as Lehman Brothers, another major participant in the municipal market, went under in late 2008. The increase in ratios was further exaggerated as market participants fled to the Treasury market as a safe haven. Ratios peaked at around 200% towards the end of 2008 and the first quarter of 2009. Meanwhile, nominal yields peaked around the same time as the ratios peaked, offering yields close to 6.00%, a phenomenon that had not been seen in the municipal high grade market for some time.

The ratio of AAA-rated municipal yields to 30-year Treasury yields spiked to an unusually high 111.6% in the early part of 2011. That compares with 107.3% at the end of 2010. A great many market players attributed this to fear-led selling by investors redeeming their holdings in municipal bond mutual funds, thus flooding the market.



Credit Spreads

Exhibit 4 compares AAA yields to A yields, AA yields and BAA yields, to demonstrate historically where spreads were as of December 31, 2010. BAA credits, along with single A credits, currently appear to offer the best value when compared to AA credits.

Although at this time we are not yet seeing a full economic recovery, there are some sectors that are performing better or recovering faster than others on a spread basis. This means that buyers are willing to pay more to own the bonds. The hospital sector provides a clear example. AA-rated hospital bonds are getting closer to fair value while there

is still some lag in the single A and BBB-rated hospital issuers. Fair value is a concept used in accounting and economics, and can be defined as a rational and unbiased estimate of the potential market price of goods, services, and assets.

An interesting point to note is that the G.O. bonds issued by the State of California, the eighth largest economy in the world, and by the State of Illinois, the 18th largest economy in the world, are trading on par with, and at times cheaper than, single A-rated hospitals. This highlights the extent of the pressures that states such as these are currently under because of budget concerns.

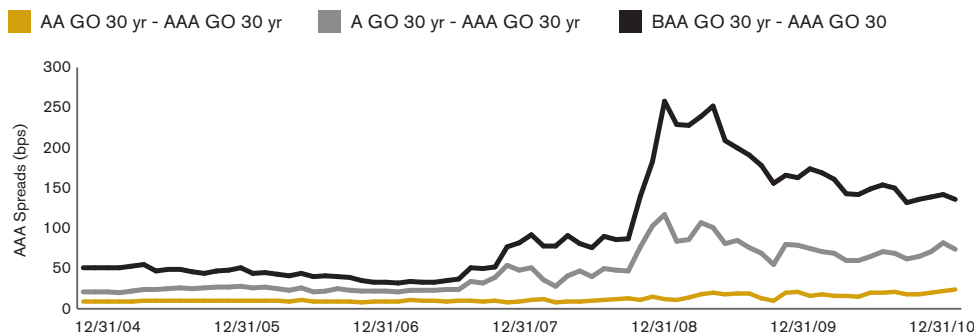
Credit concerns still exist in the municipal market which is not only reflected in the California/Illinois example, but also in Master Settlement Agreement tobacco bonds⁷ which are at the other end of the revenue spectrum. We believe that segmentation is occurring within the tobacco sector, which is related to the issue dates of the bonds. When reviewing the cash flows and cash flow assumptions on tobacco bonds, the older issues are performing as we expected with a slight extension in their average lives. However, tobacco issues that were minted later in the cycle are not, in our view, performing as well due to their structure. Consumption has declined more than expected due to increased taxation and the subsequent higher cigarette prices. This has been compounded by the banning of smoking in public places and work environments. We would expect that a consumption decline would produce a cash flow decline, which would then extend the average lives of the bonds. The more aggressive the consumption decline assumption, the greater the cash flow decline and extension of the average life of the bond.

Exhibit 4

AAA Municipals vs other Municipal Credit Spreads

12/31/04–12/31/10 (Daily)

Currently, single A's and AA's offer value.



Past performance does not guarantee future results.

Source: Thomson Financial municipal market data. This graph is historical and for illustrative purposes only.

Build America Bonds (BABs)

The American Recovery and Retirement Act of 2009 introduced BABs into the municipal bond asset class. The purpose of the BAB program was to stimulate job growth with 'shovel ready' projects. These municipal bonds had to be issued before January 1, 2011, and were taxable at the federal level and in most cases tax-exempt at the state level. The issuer received a 35% interest rate subsidy from the federal government. In order to qualify for the subsidy, the proceeds of the bond sale had to be used for capital expenditures. Bonds that qualified were General Obligation, Transportation, Public Power, Water and Sewer, and Public Higher Education. Since the program commenced in April 2009, \$180 billion BAB bonds have been sold.⁸

After receiving the subsidy, state and local governments benefited from the lower net interest costs. With the subsidy, issuers obtained lower yields on bonds than they would have in the tax-exempt market; which in turn made it more economical for issuers to issue bonds. In essence, interest rates were reduced for the issuer. Tapping the taxable market with BAB issuance opened an entirely new market for municipal issuers that was once exclusively for tax-exempt buyers.

Credit quality is higher in the municipal market than in the taxable market, which appeals to a host

of buyers who focus on quality. Municipal bonds that traditionally would have been issued in the tax-exempt market were now being issued in the taxable market. Most of the BAB supply was in the long end of the yield curve (which refers to bonds having 25-30 year maturities), which limited supply dramatically in long tax-exempt bonds. This reduced availability of tax-exempt bonds at the long end of the curve shifted supply and demand and caused those bonds to appreciate in value, which translated into lower interest rates.

While the introduction of BABs into the municipal market has helped to grow the asset class, their existence has affected the supply in the tax-exempt market. Issuers exited the tax-exempt market and entered the BAB market. Typically these high grade (refers to credit quality) issuers and high profile (typically larger issuers, such as State of California, New York City) issuers participated in the long end of the market, which had the most attractive yields. The success of the BAB program limited future tax-free supply as well as created a premium on available tax-exempt bonds.

With the sunset of the BAB program at year-end 2010, many municipalities rushed to market with new BAB issuances effectively flooding the market, which led to a downward effect on prices.

Texas Electric Utility Systems On June 7, 2010, Austin, Texas Electric Utility Systems issued bonds in the BAB market and in the tax-exempt market. Both the BAB and the tax-exempt bond issues were rated similarly by the rating agencies: Moody's A1, S&P A+ and Fitch AA-. With the subsidy, the BAB bonds were actually more cost-effective than the tax-exempt bonds. The BAB bonds were priced at 160 basis points (1.60%) over the 30 year Treasury which gave it a coupon of 5.72%. With the federal subsidy of 35%, the interest cost to the issuer was 3.77%. The tax-exempt bonds were issued at 4.75%. The issuer saved 0.98% by issuing in the BAB market.

Case Study I: Texas Electric Utility Systems



Of course, when considering investing in bonds, you should also consider the risks associated with this type of investment. Bond funds are subject to interest rate risk, credit risk and prepayment risk. When interest rates rise, bond prices generally fall, and when interest rates fall, bond prices generally rise. Currently, interest rates are at relatively low levels. Please keep in mind that in this kind of environment, the risk that bond prices may fall when interest rates rise is potentially greater.

Municipal Bankruptcies and Defaults

The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression. Since Congress established this federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed.⁹ Although Chapter 9 (municipal bankruptcy) cases are rare, a filing by a large municipality can—like the 1994 filing by Orange County, California—involve many millions of dollars in municipal debt.

“The purpose of Chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts via restructuring and reorganization. Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.”⁹

Chapter 9 is significantly different from other chapters in the bankruptcy code, in that there is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Additionally, municipalities have to get specific permission from the state (and the conditions vary from state to state) to file under Chapter 9. One such condition is the requirement for a municipality to be insolvent and have no ability to pay debts due at the time of filing or in the near future. There are approximately 26 U.S. states that do not even authorize municipalities to file for Chapter 9. U.S. states are not considered municipalities and are not afforded the relief offered to municipalities under Chapter 9.

To put the number of municipal bankruptcies into context – there were only five bankruptcy filings for municipals in 2010, compared to over 12,000 businesses that filed for Chapter 11 last year.⁹

Case Study II: Orange County, CA—Still the Largest Municipal Bankruptcy



Orange County, CA So far, the largest and best-known municipality resorting to a Chapter 9 bankruptcy filing was that of Orange County, California, whereby the bankruptcy proceedings extended from December 1994 to June 1996.⁹ Orange County never defaulted on its bonds. Instead, it delayed payments and restructured existing debt by selling AAA rated insured recovery bonds. In the end, all bondholders received their principal and interest. Another more recent filing was Vallejo, CA, which filed for Chapter 9 protection in December 2007.

Case Study III: Washington Public Power Supply System (WPPSS)— A Large Default



Washington Public Power Supply System (WPPSS) Generally, financings dependent on revenues from a specific project have provided lower recoveries than those supported by broad-based taxes or user fees. The most infamous example might be the default of the Washington Public Power Supply System (WPPSS) in 1983. WPPSS planned to construct five nuclear power plants to meet the ten-year forecasted demand for electricity in the northwest region. As challenges with the expansive project materialized, including significant construction delays and cost overruns, along with declining demand for energy in the service area, WPPSS decided to abandon the construction of projects 4 and 5. Approximately \$2.25 billion of debt associated with these projects was outstanding, payable through participation agreements with numerous municipal and cooperatively-owned electric utilities. Repayment of the debt was contingent on the participating public utilities dramatically increasing electricity rates to finance the failed projects. The resulting discord led to challenges regarding the enforceability of the participation agreements, which ultimately were invalidated by the Washington State Supreme Court. Bondholders received about 40 cents on the dollar.¹⁰

Default Levels—Then and Now

Defaults were distributed very unevenly across the U.S. during the Great Depression.¹¹ Data originally published in *The Daily Bond Buyer* show that a total of 3,159 municipalities and special districts were in default as of January 1, 1936. Of these, nearly 20% occurred in Florida where the collapse of a real estate boom in 1926 had already triggered a wave of defaults by 1927.¹¹ Municipalities in six states—Arkansas, Louisiana, Michigan, New Jersey, North Carolina, and Texas—accounted for another 45% of those in default. In other states, including New York, Wisconsin, Virginia and the New England states, very few municipalities defaulted.

Exhibit 5 details the historically low default rate of municipal bonds compared to the default rate of corporates. The 10-year average cumulative default rate for all municipals was 0.09% vs. 11.06% for corporates.¹²

There were only three G.O. defaults in the past 40 years.¹² The low default rate can be largely attributed to the fact that most municipal bonds are issued to finance infrastructure owned by the state and local governments. The funding for repayment of these bonds is provided by taxes levied on real estate, retail sales and income, plus usage fees for services like water, sewer and toll roads.

Included in the current default rate are some smaller credits that were not rated; typically referred

to as ‘dirt’ bonds, these are mostly based in Florida. A dirt bond is a bond that is issued for construction or development of a specific project. For example, it could be a housing project, for building streets, or for water and sewer infrastructure. As houses come up for sale and are purchased, new home owners pick up the tax associated with water and sewer lines. These bonds are defaulting mainly due to the fact that when they were issued in 2005–2007, real estate prices were inflated and interest rates were low.

All three major rating agencies have acknowledged that municipal bond issues probably should have slightly better ratings relative to the issuers of corporate bonds in the context of both historical default rates and recovery levels following default.¹³ In April 2010, Moody's and Fitch recalibrated their rating scale for municipal bonds, which resulted in higher ratings on many general obligation and essential service revenue bonds.

The health of states and local municipalities received widespread negative media scrutiny in late 2010. The most notable coverage was the “60 Minutes” Report focusing on the issues in Illinois, New Jersey and California.¹⁴ Such media speculation fed the already anxious retail investors, who were wary of the already falling prices. Municipal bonds experienced \$21 billion in negative flows during November and December 2010.¹⁵

Exhibit 5

10-Year Average Cumulative Default Rates (%) for Municipal and Corporate Bonds, 1970–2009

Rating	All Municipals	Corporates
Aaa	0.00	0.05
Aa	0.03	0.54
A	0.03	2.05
Baa	0.16	4.85
Ba	2.80	19.96
B	12.40	44.38
CaaC	11.60	71.38
Investment Grade	0.06	2.50
Speculative Grade	4.55	34.10
All Rated	0.09	11.06

Source: Moody's Investors Service, February 2010.

Over the past 10 years, most bond defaults have occurred in the below-investment-grade category.

Why Own Municipal Bonds

Tax-Free Income

Despite the fact that, towards the end of 2010, the Bush-era tax cuts were extended for two more years¹⁶, we believe tax rates are likely to increase at some point in the future, and when they do, demand for tax-advantaged investments will likely also increase. If, and when, current tax rates on dividends are allowed to expire at the end of 2012, the rate in the top tax bracket is set to rise from 15% to nearly 40%. Rates on ordinary income would rise to that same level from 35%. In addition, the new health care law includes a 3.8% Medicare surtax on investment income beginning in 2013 for high earners (singles earning more than \$200,000 and households earning more than \$250,000).¹⁷ Exhibit 6 demonstrates the effect on tax rates on dividends if, and when, current rates expire.

Attractive Yields

We believe municipal bonds have relatively good value across the entire yield curve – for investors in the 35% tax bracket, the taxable equivalent municipal yield is generally higher than that of corresponding Treasury issues.* For someone in the top tax bracket, a 10-year municipal yielding 3.40% today would have a taxable equivalent yield of 5.23% this year.

Exhibit 6

Effect On Tax-Rates If And When Current Rates Expire

Current Rates (%)		If And When Current Rates Expire (%)	
Ordinary Income	Qualified Dividends	Ordinary Income	Qualified Dividends
10	0	15	15
15	0	28	28
25	15	31	31
28	15	36	36
33/35	15	39.6	39.6

Large Increases

Source: Ned Davis Research, Inc. (visual). The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (figures).

*As of March 2011. Yields are subject to change.

Demographics

With the baby-boomer generation fast approaching retirement, interest in conservative, income-producing investments is likely to grow.

Low Default Rates

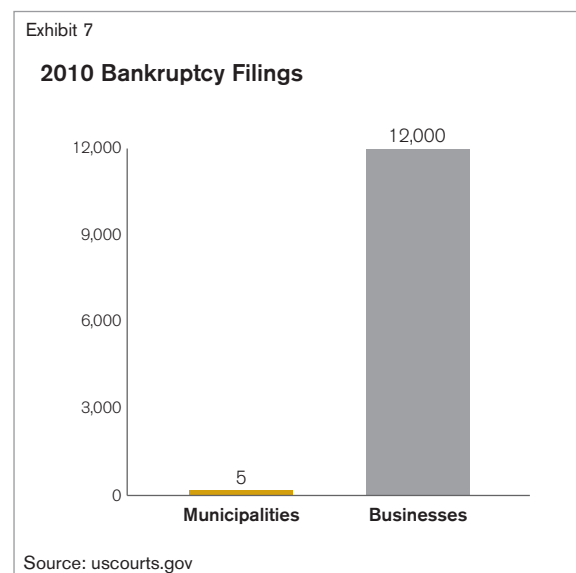
Moody's data, for bonds that it rates, details the historical low default rate of municipal bonds compared to the default rate of corporates. The 10-year average cumulative default rate for all municipals is 0.09% vs. 11.06% for corporates.¹²

Bankruptcies Have Been Rare

There were only 5 filings for municipal bankruptcies in 2010 compared to over 12,000 businesses that filed for Chapter 11 (Exhibit 7).⁹ A municipality can only file for bankruptcy once it demonstrates its complete inability to pay its debts and it receives authorization by the state to file. Even once a municipality does file, it does not mean it will default, as the earlier example of Orange County showed.

Diversification

Municipal bond returns typically are not highly correlated with equity markets, offering portfolio diversification. They can potentially provide tax-exempt income, diversification, and exposure to high quality fixed income.





RS FIXED INCOME TEAM'S PRINCIPLES:

- Uncompromising integrity
- Alignment with investors
- Intensive research
- Disciplined investment process
- Independent and dynamic thinking

The RS Fixed Income Team averages 20 years of industry experience.

Front Row: Martin Vernon, Leslie Barbi. Back Row: Alexander Grant, Howard Chin, Robert Crimmins, Howard Most, Jonathan Jankus, Kevin Booth, Stewart Johnson, and Marc Gross.

Municipal Bond Offerings from the RS Fixed Income Team

Alexander Grant has been the Portfolio Manager of RS Tax-Exempt Fund (GUTEX) since 1993, and RS High Yield Municipal Bond Fund (RSHMX) since its inception in December 2009. He is backed by the entire RS Fixed Income Team, which consists of 35 seasoned investment professionals, who on average bring 20 years of experience. The Team covers every aspect of investment strategy, portfolio management, credit analysis, trading, quantitative analysis and risk management.

RS Tax-Exempt Fund and RS High Yield Municipal Bond Fund offer compelling investment potential for investors, including attractive tax-exempt income.

In collaboration with the RS Fixed Income Team, Alexander Grant uses a disciplined investment process and intensive credit research to identify what the team believes are undervalued sectors and issues with the potential to outperform over the long term. A value-oriented approach is followed when selecting issuances and places an emphasis on

cash flow quality, while avoiding bonds that rely on appropriation, and leverage is not used in the funds.

RS fixed income funds are sub-advised by Guardian Investor Services LLC. The RS Fixed Income Team's time-tested investment process uses a combination of top-down and bottom-up research. Economic and market assessments provide the basis for portfolio structure and sector allocations, while bottom-up credit analysis helps identify promising issuers, and security structure analysis determines which specific bonds offer the greatest long-term total return potential.

These qualitative and quantitative evaluations constitute the critical daily work that leads to specific issuer selections and specific bond investments. Additional scheduled and impromptu meetings take place to assess changing markets, valuations, and opportunities as they arise. Risk management is an integral part of portfolio construction, and performance attribution provides vital feedback.

The views expressed herein are subject to change based on market, economic or other conditions and should not be construed as investment advice.

- 1 Bloomberg.com, December 2010.
- 2 Seymour, Dan. "Firms Hike Their Muni Holdings." *The Bond Buyer*. April 12, 2010.
- 3 Municipal Market Data (MMD). (www.tm3.com). Since 1982 MMD has provided a broad range of technical and fundamental analysis and tax-exempt money market data. MMD is widely recognized as the premier industry source of benchmark data.
- 4 Pre-refunded bonds are a type of bond issued to fund another callable bond, where the issuer actually decides to exercise its right to buy its bonds back before the scheduled maturity date. The proceeds from the issue of the lower yield and/or longer maturing pre-refunding bonds will usually be invested in Treasury bills (T-bills) until the scheduled call date of the original bond issue occurs.
- 5 Letter of Credits (LOCs) are frequently used by issuers of municipal securities to enhance the creditworthiness of municipal debt securities. LOCs are issued by banks or other financial institutions and typically evidence an obligation by the bank or financial institution to pay the principal and interest on a municipal security to the beneficiary of the LOC. (Chapter 61, *The Handbook of Municipal Bonds*, Editors: Sylvan Feldstein, Frank Fabozzi).
- 6 Insurance companies that provide guarantees to issuers.
- 7 On November 23, 1998 a total of 46 U.S. states, the District of Columbia, the Commonwealth of Puerto Rico, and four U.S. territories entered into the Master Settlement Agreement (MSA) with four major U.S. tobacco companies: Philip Morris Inc., R.J. Reynolds Tobacco Co., Lorillard Tobacco Co., and Brown & Williamson Tobacco Corp. This agreement represents the largest civil settlement in U.S. history. Following its execution and approval by these participants, the "settling states," have issued over \$36.5 billion of tax-exempt revenue bonds secured by a pledge of tobacco settlement revenues provided under the MSA. (*The Handbook of Municipal Bonds*, Chapter 57. Editors: Sylvan Feldstein, Frank Fabozzi).
- 8 Barclays Capital, Municipal Research, Municipal Market Commentary October 2010.
- 9 www.UScourts.gov.
- 10 The Online Encyclopedia of Washington State History (<http://www.historylink.org>).
- 11 Moody's Investors Service, Global Credit Research, January 1997, Historical Default Rates of Corporate Bond Issuers, 1920–1996. Report 21727.
- 12 Moody's Municipal Bond Defaults and Recoveries, 1970-2009, Published Feb 2010.
- 13 "Re-calibration of Moody's U.S. Municipal Ratings to its Global Rating Scale" released by Moody's on March 16, 2010, and "Re-calibration of U.S. Public Finance Ratings" released by Fitch on March 25, 2010, "Update To Global Methodologies And Assumptions" released by Standard & Poor's (S&P) on September 17, 2009, each of which can be found on the respective rating agency's websites. (www.moodys.com, www.fitchratings.com, and www.standardandpoors.com).
- 14 CBS News - 60 Minutes. (<http://www.cbsnews.com/stories/2010/12/19/60minutes/main7166220>).
- 15 "Trends in Mutual Fund Investing." Investment Company Institute. December 2010. (http://www.ici.org/research/stats/trends/trends_12_10).
- 16 On December 17, 2010, President Obama signed into law the Tax Relief, Unemployment Insurance Re-authorization and Job Creation Act of 2010, or H.R. 4853 (<http://democrats.senate.gov/pdfs/MAT10785.pdf>).
- 17 On March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act, and on March 30, 2010, he signed a companion bill, the Health Care and Education Tax Credits Reconciliation Act of 2010. Taken together, these two acts constitute what is commonly collectively referred to as the Health Care Act. (<http://www.ustrust.com/ust/pages/healthcarereform.aspx>). Please see the U.S. Government Printing Office website for a PDF of the Bill (<http://www.gpo.gov>).

As with all mutual funds, the value of an investment in the Funds could decline, so you could lose money. Bond funds are subject to interest rate risk, credit risk and prepayment risk. When interest rates rise, bond prices generally fall, and when interest rates fall, bond prices generally rise. Currently, interest rates are at relatively low levels. Please keep in mind that in this kind of environment, the risk that bond prices may fall when interest rates rise is potentially greater. Investors in the Funds may be subject to AMT and certain other state and local taxes.

RS High Yield Municipal Bond Fund: High yield bond investing includes special risks. Investments in lower rated and unrated debt securities are subject to a greater loss of principal and interest than investments in higher rated securities.

Not all funds or share classes are available at all firms. Please check with your financial advisor or representative for details.

RS Funds are sold by prospectus only. You should carefully consider the investment objectives, risks, charges, and expenses of the RS Funds before making an investment decision. The prospectus contains this and other important information. Please read it carefully before investing or sending money. To obtain a copy, please call 877-500-2388 or visit www.RSinvestments.com.

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