

Municipals: The State of Tax-Advantaged Investing

Excerpt From The Municipal Bond Market Research Paper

The municipal bond market has a long and rich history, and the municipal asset class has continued to grow and become quite sizable over the years.¹

The hierarchy of municipal bonds can be essentially split into 4 categories as Exhibit 1 details. 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. Pre-refunded bonds properly secured with U.S. Treasuries are amongst the highest credit quality of municipal bond securities.² Revenue bonds are used to finance specific public works and are supported by the revenues of that project. Enhanced bonds are insured or letter-of-credit backed bonds.³ In May 2009, with the onset of the American Recovery and Retirement Act of 2009, another type of municipal bond was temporarily introduced - Build America Bonds (BABs). BABs were federally issued taxable bonds (and in most cases tax-exempt at state level) that could be issued only for specific purposes, such as infrastructure needs, education, and transportation. Their existence affected supply in the tax-exempt market, as issuers exited the tax-exempt market and entered the BAB market. The BAB program ceased to exist at year-end 2010.

A way to measure the relative value of municipal bonds is to divide the hypothetical AAA municipal bond yield by the corresponding Treasury yield. Historically, 30-year municipal bonds have been considered fairly valued at an approximately ratio of 89%. The higher the ratio, the cheaper the municipal bonds are; anything below 89%

is considered expensive.⁴ Towards the end of 2010, the ratio of AAA-rated municipal yields to 30-year Treasury yields was 107%.

Chapter 9, the legislation specifically established to deal with the resolution of municipal debts, was established in 1934. Although Chapter 9 filings are rare—there were only five municipal bankruptcy filings in 2010, compared to over 12,000 business⁵ that filed for Chapter 11—filings by a large municipality can involve millions of dollars in municipal debt. Despite the fact that the 10-year average cumulative default rate for all municipals was 0.09% vs 11.06% for corporate bonds⁶, towards the end of 2010, the health of individual states and local municipalities received negative media scrutiny focusing on the issues in Illinois, New Jersey and California.⁷ Such negative press resulted in fear-led selling by already anxious retail investors.

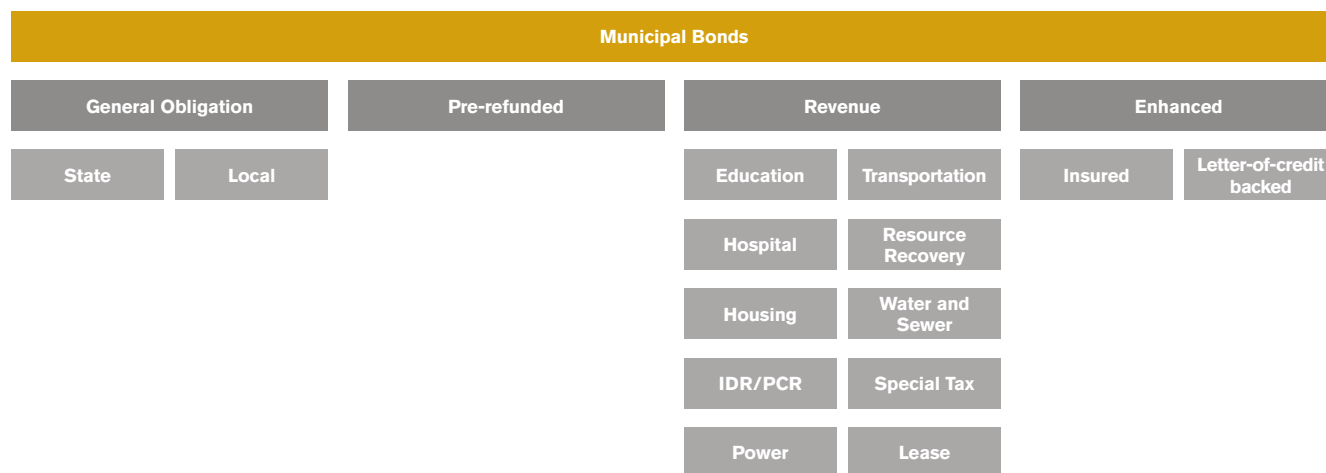
Municipal bonds can offer compelling investment potential for investors. Benefits may include:

- Interest income that is generally tax-free, and in some cases, may also be exempt from state and local taxes*
- Low historical default rates⁶
- 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

To access the full version of the research paper, please visit www.RSinvestments.com.

Exhibit 1

Municipal Bond Hierarchy



Source: Guardian Investor Services

*Some municipal bonds may be subject to the federal Alternative Minimum Tax (AMT).

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

1 Bloomberg.com, December 2010.

2 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 bond will usually be invested in Treasury bills (T-bills) until the scheduled call date of the original bond issue occurs.

3 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).

4 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.

5 www.UScourts.gov.

6 Moody's Municipal Bond Defaults and Recoveries, 1970-2009, Published Feb 2010.

7 CBS News - 60 Minutes. (<http://www.cbsnews.com/stories/2010/12/19/60minutes/main7166220>).

Any discussions of specific securities should not be considered a recommendation to buy or sell those securities. Fund holdings will vary.

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 may be subject to AMT and certain other state and local taxes. 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.

RS Funds are sold by prospectus only. Your clients 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 have your clients read it carefully before investing or sending money. To obtain a copy, please call 877-500-2388 or visit www.RSinvestments.com.

RS Investments is an independent subsidiary of Guardian Investor Services LLC (GIS). GIS is a registered broker-dealer, registered investment advisor, and a wholly owned subsidiary of The Guardian Life Insurance Company of America.

Distributed by: GIS, 7 Hanover Square, New York, NY 10004

Guardian Investor Services LLC (GIS) is a member: FINRA, SIPC.

Not a Deposit | Not FDIC or NCUA Insured | May Lose Value | No Bank or Credit Union Guarantee