

Municipal Fixed Income

Q & A: Challenges and opportunities in today's municipal bond market

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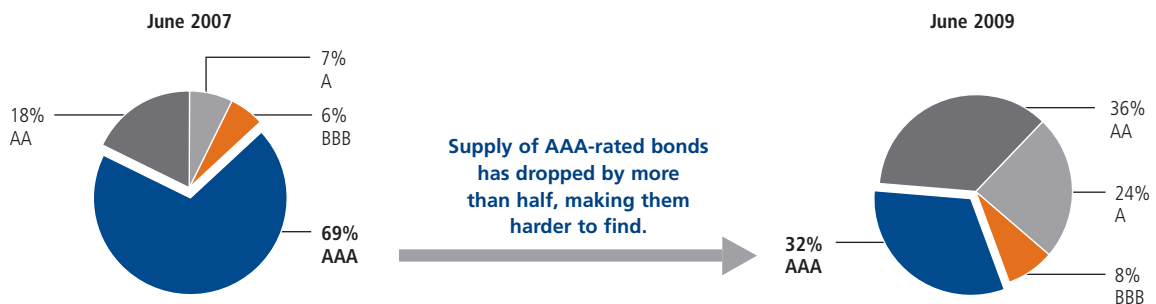
In the aftermath of the 2008 credit crisis, the municipal bond market has undergone a fundamental evolution: The strength of monoline insurers, once a mainstay of the municipal market, as effective raters of municipal bonds has been called into question. This crisis of confidence in the insurers has had two dramatic results: It has drastically cut the supply of newly issued AAA-rated municipal bonds, and it has cast doubt on the value of insurance for existing municipal bond portfolios. Furthermore, the downgrading of the bond insurers has shined the spotlight on the need for fundamental credit analysis of municipal securities.

With a view to helping clients understand today's municipal bond market, as well as the investment opportunities and challenges it presents, we are pleased to provide you with this Q&A. In it, our Municipal Fixed Income team, headed by Ebby Gerry, shares its insights into the new municipal fixed income landscape.

Q: How has the municipal bond market changed, and what has caused this dramatic shift?

A: The credit characteristics of the municipal bond market have changed dramatically. Notably, the supply of AAA-rated insured bonds between June 2007 and June 2009 has dropped by more than half, from nearly 70% of investment grade bonds to just over 30%. The downgrading of monoline insurers, which guarantee municipal bonds against the risk of default, has resulted in the insured bonds carrying the bond insurer's new lower rating. In the case of some bond insurers, these ratings can be below investment grade. The result: Investors can no longer rely on credit ratings alone as indicators of municipal bond safety.¹ With the underlying credit health of municipal issuers now a greater concern, professional management that includes a focus on in-depth credit analysis has become more important today than ever.

With the downgrading of monoline insurers, credit ratings have become unreliable as indicators of municipal bond safety—making extensive and rigorous credit research even more critical.



Source: Barclays Capital, June 30, 2009.

Please see the disclosure section for an explanation of the credit ratings.

¹ Source: BAML Muni Credit Analytics, 7-30-09: Over the course of the credit crisis, MBIA, Ambac, FGIC and XLCA have lost their AAA ratings from the three major rating agencies (Standard & Poor's, Moody's and Fitch). Only BHAC, Assured Guaranty and FSA (now part of Assured Guaranty) retain AAA ratings from Standard & Poor's. As the credit ratings for monoline insurers have dropped, so have the corresponding ratings for the bonds they had insured, making them less valuable.

Q: What are the implications both for an investor with a muni bond portfolio that predates the 2008 crisis, and for the investor who is seeking to invest in municipal bonds today?

A: In the absence of credit-quality guarantees issued by monoline insurers, knowing what is in a muni bond portfolio is a crucial issue to research before investing. Because of the demise of the bond insurers' ratings, the overall credit quality of a municipal bond portfolio today may have changed from what it was two years ago. Some bonds' ratings may have gone from AAA to AA, or even BBB.

This focus on credit research is integral to our careful risk management process. Rather than relying on monoline guarantees, we scrutinize the underlying issuers using our own proprietary municipal credit review process to produce our own internal ratings. We were conducting in-depth credit analysis long before the status of monoline insurers was in question.

Q: What impact is the recent market upturn having on the municipal bond market?

A: With the negative effects of the credit crisis gradually receding, and signs that the economy may be improving, investors appear to be turning less risk averse. Additionally, current government policies have led some to believe that future tax increases can only be around the corner, further raising awareness of tax-efficient vehicles such as municipal bonds. The renewed investor confidence is leading to record inflows into municipal bonds. Through September of this year, investors pumped nearly \$56 billion in net new cash into municipal bond mutual funds, compared with \$27 billion during the same period a year ago.²

Further spurring investors is the modest gain generated by the US bond market through the third quarter of this year, with the municipal bond market significantly outperforming its taxable bond counterparts during this period. This positive performance has fueled strong demand for tax-free bonds, which has supported municipal bond prices. All told, the Barclays Capital Municipal Bond Index returned 14.00% during the nine months ended September 30, 2009.

Q: How are today's supply/demand dynamics affecting municipal bond transactions?

A: The rise in municipal bond demand has been accompanied by a sharp drop in supply; compared to 2008, new municipal bond issues are down over 15% through September of 2009. In addition, the issuance of Build America Bonds, which since April has averaged \$5.6 billion monthly for these taxable bonds, has significantly eaten into the municipal tax-exempt supply.^{3,4} At the same time, new municipal bond mutual fund inflows, as noted above, are at unprecedented levels, contributing to the supply/demand imbalance.

We believe the supply/demand dynamics are creating potential opportunities for investors as significant mispricings exist in the market. Illiquidity, however, continues to plague the market, making price discovery difficult and bid-ask spreads wide across securities, sectors and rating categories.⁵ In this environment, we believe providing clients with a portfolio that is professionally managed has become increasingly critical.

Q: Given the budget problems faced by California, and other states and municipalities, how is the Municipal Fixed Income team positioning its portfolios with respect to bonds from these issuers?

A: In the short term, we continue to stay negative on and underweight to California, given its budget problems. While these budget problems have created fodder for a slew of negative headlines, there is a big difference between spending deficits and defaults, and we don't expect that the state will go bankrupt. California's budget deficit raises a credit

² Source: AMG Liquidity Data Analysis.

³ Source: Barclays Capital Municipal Market Commentary, September 4, 2009.

⁴ Source: U.S. Treasury Department Office of Public Affairs and www.irs.gov. The Build America Bonds (BABs) program, created by the American Recovery and Reinvestment Act of 2009, authorizes state and local governments to issue these bonds in 2009 and 2010 to finance any capital expenditures for which they otherwise could issue tax-exempt governmental bonds. The program is designed to assist state and local governments in financing capital projects at lower borrowing costs and to stimulate the economy and create jobs. Unlike municipal bonds, the income BABs generate is taxable. There are two general types of BABs: One type gives issuers a federal government subsidy of 35% of the interest paid to investors for purchasing the bonds; the other type gives BABs holders a tax credit from the federal government equal to 35% of the interest on the bonds each year.

⁵ The bid-ask spread is the difference between what dealers pay and charge for the same bond. A wide bid-ask spread is essentially a penalty incurred by investors who try to buy and sell into an illiquid market.

concern, where we see some downgrades occurring, but not a default. We anticipate that the next headline will be California's issuance of over \$8 billion in revenue notes to meet its cash flow operating needs. In our opinion, the ability of the state to successfully access the market is a new positive, but in no way do we see the state's finances as being out of the woods yet.

Historically, default rates in the investment grade municipal arena are below 1%. Though municipalities are challenged today to effectively manage their finances given a declining revenue stream and ever-rising expenses, we don't expect to see a wave of defaults because states and municipalities have numerous tools to enhance and increase their revenue streams and reduce their expenditures. We must note, however, that the outlook for municipal issuers is negative and, therefore, we expect rating agency downgrades to outpace upgrades for the foreseeable future. In this environment, we are relying on our rigorous credit research to select those municipal credits that are better prepared to cover their expenses and liabilities.

Q: How would the Municipal Fixed Income team manage its portfolios in a rising interest rate environment?

A: We follow a consistent and disciplined strategy that is predicated on not trying to time the market. Over the past 15 years, our experienced portfolio management and credit team has been through multiple credit and interest rate cycles. During all points in each cycle, we try to take advantage of inefficiencies across the yield curve, sectors and credits. In a rising rate environment, we continue to seek to advantageously position our portfolios to the yield curve in an effort to benefit from the best risk/reward relationships. It is important to note that although principal may decrease in a rising rate environment, the decreases are generally offset by increased coupon flow.

Q: What benefit or value added can a professional asset manager provide in the current illiquid market environment?

A: A professional manager can offer price discovery and price execution as key benefits to clients. This translates into knowing when to buy the right bonds at the right price for an individual portfolio. Additionally, with a built-in incentive to provide higher total return to clients, the manager will seek to minimize the spread on bonds purchased.

UBS Global Asset Management manages nearly \$16 billion in municipal fixed income assets, and is one of the largest players in the municipal bond market.⁶ Through our trading desk, we have a relationship with some 65 broker/dealers, potentially enabling us to provide our clients with access to a broader array of municipal securities. Because we execute transactions at institutional trading volumes, we also can offer competitive pricing to our clients.

Q: What is the team's outlook for the balance of 2009?

A: With the economic recovery still in progress, continuing distress in the housing market and high unemployment, we believe the Federal Reserve Board is likely to keep the fed funds rate low to make sure that any nascent turnaround gains traction. We, therefore, don't feel inflation is going to present a problem for the municipal market for the balance of this year and into 2010.

Based on our fundamental analysis, we believe municipal bonds are an opportunity now due to significant pricing inefficiencies. We seek to add value by capitalizing on these inefficiencies across different sectors, maturities, bond structures and issuers. We believe our investment strategy—with its focus on underlying credit research and enhanced risk management—will enable us to capitalize on these opportunities and deliver consistent, above-average returns, benefiting our clients' portfolios.

The views expressed are as of September 30, 2009. This publication is a general guide to the views of UBS Global Asset Management's Municipal Fixed Income team.

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⁶ As of June 30, 2009.

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Disclosures:

The Barclays Capital Municipal Bond Index includes investment grade, tax-exempt and fixed-rate bonds with long-term maturities (greater than two years) selected from issues larger than \$50 million. The index is unmanaged, performance does not reflect the deductions of any fees or expenses, and the index is not available for direct investment.

Credit ratings are used by the rating services to express forward-looking opinions about the relative credit quality of municipal bond issuers. The key objective is to provide a rank ordering of the relative creditworthiness—that is, whether a bond will be paid according to its contractual terms—by the issuer, with the likelihood of default being the single most important dimension of creditworthiness. The following table shows the comparable investment grade ratings of the three major rating agencies, with generally, bonds rated BBB, or better, by Standard & Poor’s and Fitch, or Baa by Moody’s, respectively, considered to be “Investment Grade”:

	Moody’s	Standard & Poor’s	Fitch
Highest credit quality	Aaa	AAA	AAA
Very high credit quality	Aa	AA	AA
High credit quality	A	A	A
Good credit quality	Baa	BBB	BBB

Source: Moody’s, Standard & Poor’s and Fitch.

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