

Point-of-View Report

THE GLOBAL SEARCH FOR YIELD

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What's wrong with this picture?

Investors have taken a global and what some might say a cavalier stance in combing the markets for yield. This quest is in marked contrast to investor risk preferences of just a few years ago. Until recently U. S investors took a parochial attitude toward investing, eschewing the then significantly higher yields of emerging and even in many cases developed markets in exchange for greater principal protection, higher credit quality, absence of currency or political risk and lower volatility of US treasury, agency and high grade corporate debt. They've been driven in part as a result of low level of yields globally.

Figure 1.0

Issuer	Yield	Credit Rating
International Bonds		
Russia	5.56%	BBB
Columbia	6.13%	BB
Brazil	6.56%	BB-
Turkey	6.38%	BB-
U.S. Corporate Bonds		
BB Corporate Index	7.07%	BB
American Airlines	6.97%	BB+
GMAC	7.86%	BB

Global yield tables such as this one (Figure 1.0) are a good template for the tax exempt institution. But what about the taxable U S investor? The comparative yield shopping that is taking place in the global market today does not adjust for taxes. U.S. taxable investors need to compare these yield profiles with the tax adjusted returns available in the municipal market (Figure 2.0). When they do that, they will be in for a pleasant surprise. The tax adjusted yields on highest quality municipal bonds provide equal or greater yield than all but the riskiest of credits.

Figure 2.0

Issuer	Yield	Credit Rating
U.S. Municipal Bond		
Insured New York Municipal Bond	7.80%*	AAA
International Bonds		
Russia	5.56%	BBB
Columbia	6.13%	BB
Brazil	6.56%	BB-
Turkey	6.38%	BB-
U.S. Corporate Bonds		
BB Corporate Index	7.07%	BB
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GMAC	7.86%	BB

* Assumes the investor is in the highest combined Federal marginal tax bracket and state tax bracket.

In analyzing and comparing markets by yield today we note that US government securities yield more than any of their counterparties in Western Europe and Japan. In some cases the yield differentials are dramatic. 10 Year US treasuries yield 30 % more than the core EU countries comparable government debt, and more than double that of Switzerland.

So where are investors going for yield? The answer is to developing or emerging markets and lower quality corporate debt. Investors have been voting with their feet – stampeding into the debt of below

investment grade US and international corporate issuers and emerging countries that just a few years ago traded at distressed levels. Some of the most actively traded credits today were in reorganization or in debt moratoriums.

Consider the example of Brazil Government bonds. Spreads to US Treasuries have undergone enormous contraction. Since mid-2002 the incremental yield obtained by investing in Brazilian government bonds compared to U.S. Government bonds has contracted from almost 7.5% to less than 2% today. Or Russian government bonds that have gone from default in 1998 to just 56 basis points more in yield than U.S. treasuries.

Full US tax payers and AMT Tax payers would be advised to look closer to home. Highest quality municipal bonds offer principal protection, liquidity, absence of political or currency risk, low volatility and when one compares their yields on a tax adjusted basis they offer greater income than all but the riskiest credits in the world.

Why are municipal bonds so attractively priced relative to taxable securities? There are several explanations for the attractive tax adjusted yields of municipal bonds that simply cannot be overlooked by the taxable investor.

Yield curves in the US and globally are driven by future expectations for interest rates and sensitivity to credit quality. In addition to interest rate and credit uncertainty, the municipal yield curve compensates investors for tax uncertainty, liquidity and structural imbalance between supply and demand.

The municipal yield curve is much more positively sloped than the yield curves of taxable markets. Unlike the US treasury market where the great preponderance of debt is short term in tenor, municipalities issued more than six times as much long term debt as short term in 2004. Since income is tax exempt, most investor interest is driven by retail investors and select property casualty companies. Notably absent for the moment are the traditional buyers of long term debt- pension funds, endowments, foreign central banks.

Not only do municipal bonds offer superior tax adjusted yields, they also have superior default histories to that of corporate bonds. Both Moody's and Standard & Poor's studies have shown that Municipal bonds have significantly lower default rates than corporate bonds.¹ The heterogeneity of the municipal bond market is a factor contributing to higher yields for investors. The municipal market is much more heterogeneous than the major global government markets or actively traded emerging markets.

The municipal market is approximately \$1.9 Trillion in size with one million different securities but average trading volume is less than 12 % of Treasury trading volume. A 2005 Federal Reserve Bank study estimates that this liquidity risk premium accounts for 65 basis points of additional yield on AAA rated municipal bonds relative to treasury bonds.²

Municipal bonds are among the least volatile category of fixed income investments. The absence of trading by US and global tax exempt market participants results in sharply lower volatility in this asset class.

References:

¹ Colleen Woodell, William Montrone, and Brooks Brady, "U.S. Municipal Ratings Transitions and Defaults, 1986-2005," Standard & Poor's (March 30, 2005) and Lisa Washburn, et al., "Special Comment: Moody's US Municipal Bond Rating Scale," Moody's Investors Service, Inc. (November 2002)

² Junbo Wang, Chunchi Wu, and Frank Zhang, "Liquidity, Default, Taxes and Yields on Municipal Bonds," Finance and Federal Reserve Board, Washington D.C. Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, (July 8, 2005)