The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Municipal Securities

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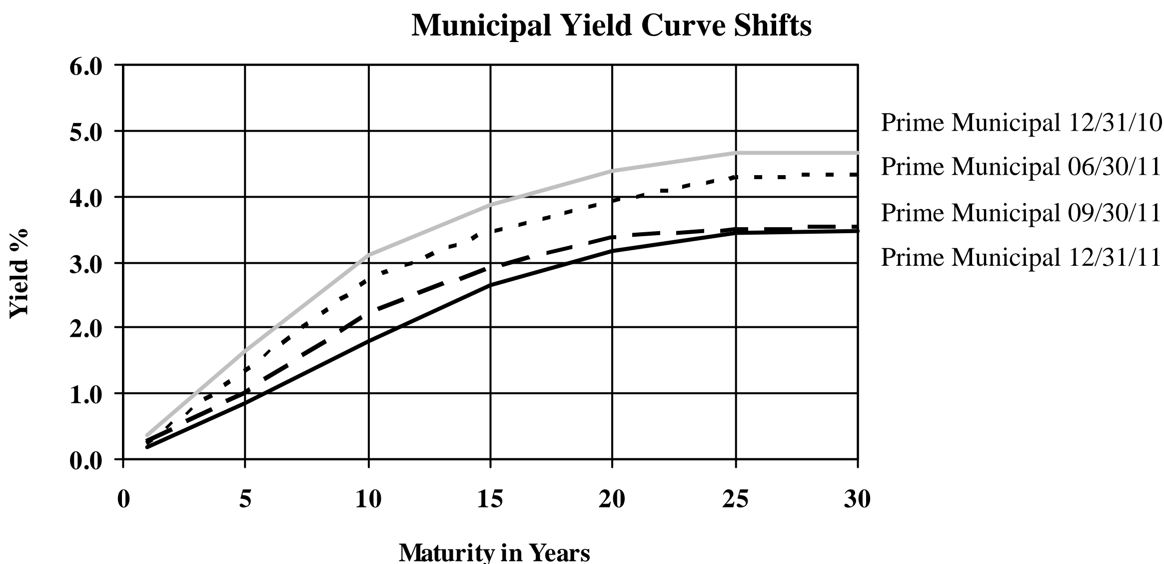
- **Banner Year For Bonds**

Investors rushed into fixed income securities during the year as they sought a safe harbor in reaction to political upheaval in the Middle East, the Euro zone debt crisis, equity market volatility, partisan wrangling in Washington, etc. The ten year Treasury traded at 3.39% at the end of 2010 and closed last year at under 2% after bottoming at 1.72% in late September. Double digit total returns were recorded in many longer maturity segments of the fixed income market.

Municipals followed the lead of the Treasury market. As shown in the following chart depicting prime tax-exempt yield curves, rates declined throughout much of the year.



In addition to the flight to quality, the municipal market was also impacted by sharply reduced new issue volume in 2011. Approximately $295 billion new bonds were sold last year, a ten year low and a 32% drop from the record $433 billion 2010 volume. New commitments to the municipal market combined with reinvestments from maturing and called bonds created strong demand for the limited volume of new bonds. Investors that purchased longer maturity securities were generously rewarded in this environment. The table below illustrates the returns of the Barclays GO Municipal Index components.

As a reminder, our short term product accounts are measured against the one year index and our traditional accounts in relation to the five year index. Both products have conservative constructions to control volatility risk. Our primary objective in managing municipal portfolios is to not incur total return losses in any year. Limiting portfolio durations provides confidence that this objective will be met.

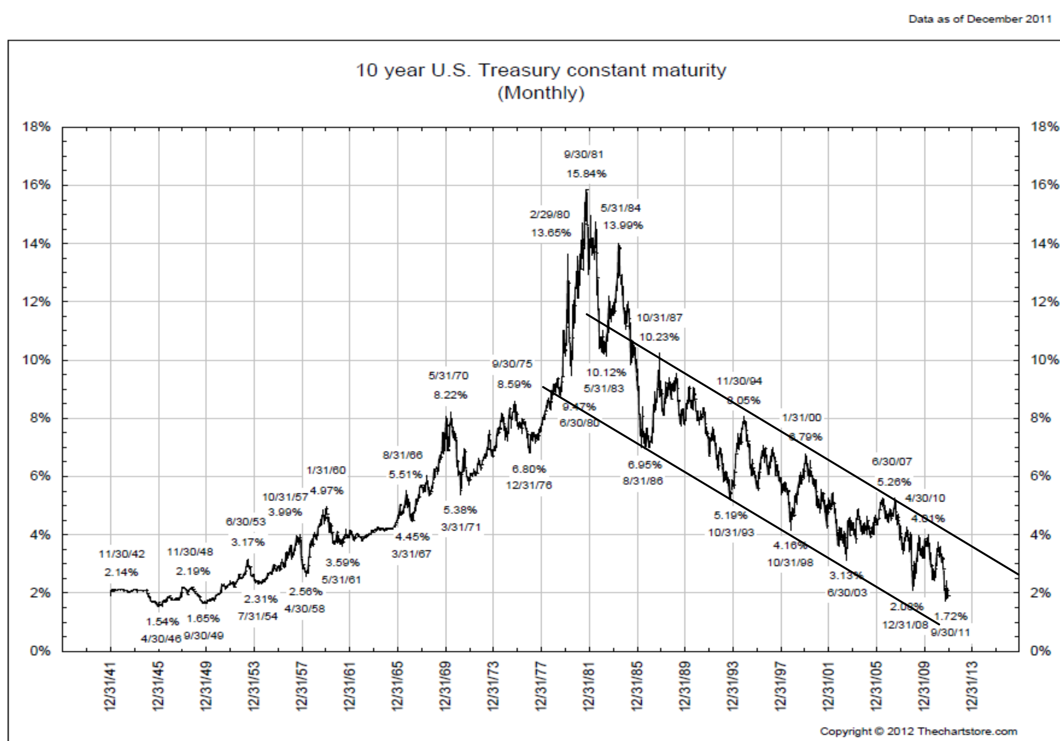
Municipal Market GO Index Returns

	Maturities In Index	2011 Total Return
1 Year	1 – 2 Yrs	1.55%
3 Year	2 – 4	3.50
5 Year	4 – 6	6.91
7 Year	6 – 8	10.58
10 Year	8 – 12	12.58
15 Year	12 -17	13.67
Long	17+	16.10

- **Outlook**

Capital appreciation accounted for a large component of the returns realized in longer maturity securities last year as interest rates fell dramatically. Assuming that a sharp economic contraction and/or deflation are not in the cards this year, further interest rate declines are likely to be limited. The economy appears to have established sufficient footing for real growth to move forward at a two to three percent annual rate over the next several quarters despite continued drags from the housing sector and high unemployment. The Federal Reserve has indicated that monetary policy will remain very accommodative in this limited growth environment. Short rates are expected to remain near zero into 2013.

We have shown the following chart, courtesy of The Chart Store, on several occasions and feel that it is appropriate to do so again. Interest rates have been on a downward path for thirty years. We expect that they are nearing a bottom. The bottoming process may be protracted, but we expect rates to eventually move higher. Signs of stronger growth and/or rekindled inflation could cause the flight to quality to reverse and bring bond vigilantes out of hibernation. Low nominal and limited real returns call for caution. We are maintaining portfolio durations at about 3.6 years, unchanged from last quarter. Should rates move still lower or signs of stronger growth emerge, we will likely reduce durations further. We continue to focus on identifying high quality securities with unique structures to enhance returns.



- **Meredith Whitney Was Wrong**

Her prediction on *60 Minutes* in late 2010 that billions of municipal bond defaults would occur this past year was dramatically off the mark. We pointed out in our newsletter a year ago that we expected budgetary stress to continue, but that the vast majority of municipalities would take appropriate steps to assure that revenues and expenditures remained in reasonable balance. This has proven to be the case. Bankruptcies did not soar. In fact, as measured by S&P, they actually declined from 2010 to 2011. Municipalities have had an excellent record of taking appropriate steps to maintain financial integrity. This record, for the most part, has been enhanced during the recent economic downturn.

Many municipalities are doing reasonably well and we anticipate that municipal budgets will further improve as the economy gains momentum. However, given the sluggish pace of the recovery, diligence remains imperative as some municipalities continue to be challenged. Our security selection has always focused on identifying high quality securities with strong credit characteristics and good liquidity. We have intensified this process. We consider credit research to be the fundamental building block in our investment process.

- **High Coupon Securities**

We continue to employ high coupon bonds in our portfolio construction. These securities have defensive characteristics (cushion effect) that can dampen price declines in rising rate environments and significantly lessen deminimis risk. Also, since some buyers are reluctant to purchase premium bonds with high dollar prices, high coupon bonds trade at higher yields to call or maturity than par bonds.

As an example, a ten year prime municipal priced near par is currently yielding about 1.88%. We are purchasing high coupon (e.g. 5%) twelve to thirteen year maturity bonds with ten year calls at yields to call ranging from 2.40% to 2.70% (a substantial yield advantage over par bonds). Assuming a bond with this structure is purchased at a 2.60% yield to call, the dollar price would be $121.01. The current return (coupon divided by dollar price) is 4.13%. The 2.60% YTC accounts for both the income received and the amortization of the premium paid for the security. This figure reflects what is being earned. We encourage clients to withdraw only what assets are "earning", not what they are "paying", to avoid eroding principal.

High coupon bonds with intermediate maturities and current calls have the potential to provide significantly enhanced returns with minimal volatility risk. This is a preferred investment vehicle in the short component of our barbell constructed portfolios and in our short term product accounts. For example, we are currently purchasing five year maturity bonds with six month calls at about a 0.30% yield to call. The dollar price on this security, assuming a 5% coupon and a par call, is $102.346. The current yield is 4.89%. The attractiveness of this structure is that, if the bond is not called, the return for one year rises to 2.61%, essentially the same return as on the long bond with a ten year call described in the example above. If this bond is not called for two years the return climbs to 3.77% and, if it remains outstanding until maturity, a 4.47% annualized return is realized.

- **Money Fund Outlook**

SEC rules mandate quality standards, liquidity parameters, diversification rules and maturity limits for money market funds. Historically these vehicles have provided reasonable short term returns and excellent liquidity. Now, however, with the Federal Reserve targeting short term rates at near zero, money market funds are providing minimal yields of just a few basis points. Many mutual fund companies have had to rebate fees to maintain positive yields. This situation is expected to persist throughout the current year and possibly beyond. We are therefore attempting to keep cash balances in client accounts at minimal levels.

Our short term product provides an attractive money fund alternative for cash balances with reasonably long time horizons – six months and longer. Utilization of longer effective maturity instruments than allowed under SEC money fund rules provides the potential to garner stronger returns. By investing in high coupon intermediate bonds with short calls (described above) in conjunction with curve roll down strategies, we have been able to provide attractive returns with minimal volatility risk.

- **Federal Budget Uncertainty**

Partisanship continues to grip Washington which has prevented meaningful legislation designed to curb spending and raise revenues. The most recent failure was the bipartisan Super Committee's inability to agree on $1.5 trillion expenditure cuts over ten years. The table is now set for $1.2 trillion automatic cuts starting next year unless legislation is enacted that curtails or offsets these mandated cuts.

Budget uncertainty will almost certainly persist during the current election year and meaningful overhaul will likely be delayed until 2013. Band aids and stop gap measures sufficient to keep the ship of state afloat are probably all that can be enacted until the election is decided. Proposals have surfaced to limit deductions; mortgage interest, property taxes, employer health care expenses and municipal interest. Whether fundamental overhaul of the tax code gains momentum remains to be seen. Whatever might happen, municipal investors should focus on the fact that the tax-exemption of current municipal securities is almost certain to remain in place and not be impaired.

- **Firm News**

C.W. Henderson & Associates ended the year with in excess of $3 billion in assets under management. We thank our clients, business partners and friends for your continued confidence and support. Providing professional municipal bond investment management and superior client service remain our primary objectives.

We sincerely wish everyone a healthy and prosperous New Year.

Craig W. Henderson **Thomas L. Mallman, CFA**

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