A Taxing Environment

Over the last several weeks municipal bond yields have once again divorced themselves from their relationship with Treasury bond yields. Frequently, these interest rate markets have been fairly well banded, but for the second time this year there is additional pressure being exerted on tax-free securities.

There will be no attempt here to minimize the difficult environment that the municipal bond market has been going through. This is evidenced by the month to-date performance of the Lehman Bros. Municipal Bond Index which is (- 1.72%).

Some of the relevant forces are as follows:

- The continued erosion in the financial health of the Monoline insurers, caused by their decision to offer guarantees on more complicated structured corporate finance instruments.
- The resultant de-leveraging from arbitrage accounts.
- The growing exodus of some large broker/dealers from the municipal business.
- A reduction in the risk appetite among the larger broker/dealers following sizeable write-downs in their capital base.
- A larger than anticipated new-issue calendar has created a supply-to-demand imbalance.

These types of changes can affect investor psychology most profoundly because they are structural in nature and seem to change the very character of the asset class. However, as with all fundamental changes there can be unrecognized opportunity if we only look past the headlines. In fact, the dynamics outlined above have formed the following investment landscape.

- 10-year municipal yields at roughly 100% of Treasury yields – ratios that are historically quite temporary and have resulted in above average relative returns.
- Moody's has announced that they will assess the credit risk of municipal bonds with the same "yardstick" as they use for corporate bonds. This will have the effect of assigning higher rating levels to the majority of tax-exempt issuers. Even if you believe that this change is politically motivated, it is a fact that for many years a municipal "AA" rating was equivalent to a corporate "AAA". After Moody's completes their ratings revisions a more accurate representation of creditworthiness will be installed. The should result in a market where approximately 96% of the credits will be "AA" or "AAA".
- One of these rare periods when municipals traded at 100% of Treasuries occurred in the 1980's when there was talk of a flat tax. I reflect on those days because what is so extraordinary about this challenging period is that it is occurring in front of an election that will probably result in higher income taxes.

It is precisely at times like these that a disciplined and methodical approach should yield long term positive results.

Robert S. Waas
Managing Member

This document is not intended to be a solicitation of Firm interests. Past Performance does not guarantee future results. Investments are subject to risk and may lose value. The information is not warranted as to completeness or accuracy, nor does it serve as an official record of your account. RSW Investments does not render legal, accounting, or tax advice. Please consult your tax or legal advisors before taking any action that may have tax consequences.

This report has been prepared by, and reflects the views as of this date of, RSW Investments, LLC [RSW hereafter]. RSW's views and opinions are subject to change. Investors should consult their attorney, accountant, and/or tax professional for advice concerning their particular situation.

All views expressed in the research report accurately reflect the Managing Member's personal views about any and all of the subject topics. No part of the Managing Member's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed by the Managing Member in the research report.