

# Build America Bonds

March 2010

Build America Bonds (BABs) are debt instruments which were created in February 2009 as a stimulus measure by the American Recovery and Reinvestment Act. BABs were conceived to provide an alternative form of financing for state and local governments in an effort to lower issuer interest costs and stimulate economic activity. While BABs are relatively new to the fixed income marketplace, they are recognized as part of the taxable municipal bond sector which has been in existence since 1986. As taxable securities, BABs increase the potential investor base for municipal issuers by allowing access to investors in the conventional corporate debt market. They are most commonly structured as issuer subsidy bonds but can also be brought to market as investor tax credit bonds. The subsidy is either paid to the issuer by the U.S. Treasury on the coupon date or received as a tax credit by the investor. Municipalities can currently achieve lower net financing costs through BABs based on the 35% interest expense subsidy paid or investor tax credit received. An expanded investor base and lower financing costs have helped to fiscally strengthen state and local governments and stimulate the U.S. economy through added public works projects.

Traditionally, taxable municipal bonds are issued when a State has exceeded its annual Federal mandate (cap) on the volume of private activity bonds it is permitted to originate at tax-exempt rates. They are referred to as private activity bonds because they are issued to finance projects that do not benefit the public at large. Examples include: replenishing an underfunded municipal pension plan, or financing projects such as local sports facilities and investor-led housing. BABs, however, are only eligible to be issued for governmental purposes that are deemed to benefit the public at large. Including BABs, taxable municipal bonds now account for approximately 6% of the \$2.7 trillion municipal bond market.

BABs have thrived since inception and are having a profound influence on the dynamics of the fixed income marketplace. Since April 2009, 984 issuances totaling \$83 billion in BABs have been brought to market. This accounts for more than 85% of the \$97

billion in taxable municipal bond sales and 28% of total municipal sales occurring over the same period. That is a significant increase in comparison to the 6 years prior to 2009 when taxable municipal issuance averaged only 5% of total municipal issuance. It is expected that \$150 billion BABs will be brought to market over the remainder of 2010 which is expected to account for 33% of total municipal issuance. The majority of these bonds will likely be issued in the 10 to 30 year maturity range where the subsidy effect is most pronounced. Although it remains relatively small, taxable municipal representation in the Barclays Capital credit indices has more than doubled since January 2009 and it is expected to have increased by a factor of 5 by the end of this year.

As illustrated below, the Barclays Capital taxable municipal bond index is generally higher in credit quality than the U.S. credit index, which is primarily composed of corporate bonds.

	Taxable Municipal Index	U.S. Credit Index
AAA	5%	9%
AA	40%	16%
A	35%	40%
BBB	20%	35%

Source: Barclays Capital

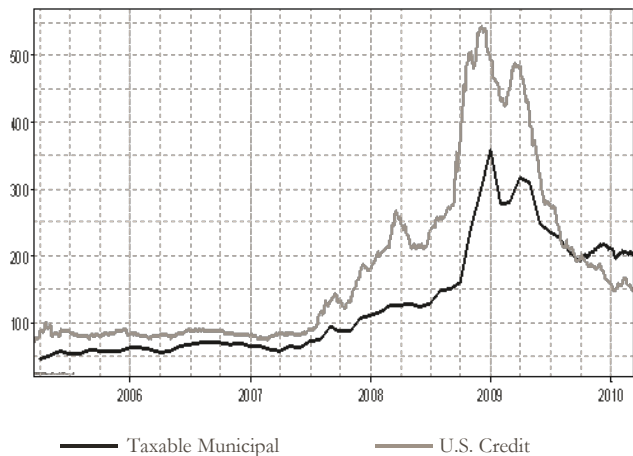
With respect to relative value, taxable municipal bonds currently exhibit a higher yield spread (the difference between the yield on a bond and a similar maturity Treasury security) for a given level of credit quality than bonds in the U.S. credit index:

	Taxable Municipal Index	U.S. Credit Index
AAA	+91	+33
AA	+153	+111
A	+204	+165
BBB	+338	+205

Source: Barclays Capital

As illustrated by the following five year graph, taxable municipal yield spreads have traditionally been lower than U.S. credit yield spreads.

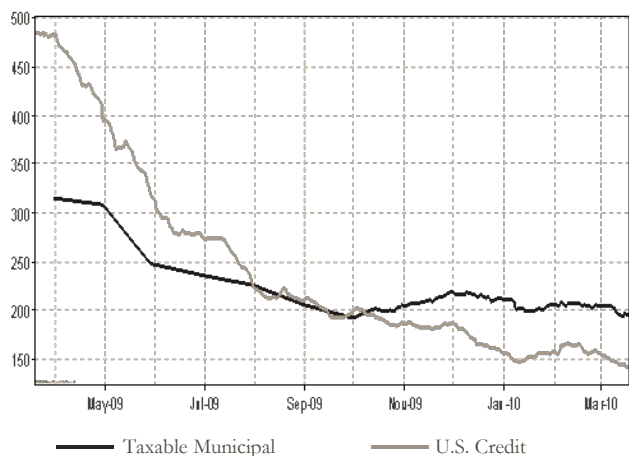
5 Year Spread History



Source: Barclays Capital

The recent reversal in this yield spread relationship is explained by the significant impact that BABs issuance has had on taxable municipal supply. Over the past year, this increased supply has pressured taxable municipal yields higher relative to U.S. credit yields.

1 Year Spread History



Source: Barclays Capital

If yield spreads revert to their normal relationship over time, it is likely the taxable municipal sector will outperform the U.S. credit sector. If taxable municipal yield spreads stay higher than U.S. credit spreads, investors will continue earning higher yields on superior credit quality.

The future for BABs looks bright. The Obama Administration is proposing legislation which would extend the ability for municipalities to issue BABs beyond 2010. Several modifications are incorporated in the proposal which would change the rulebook for issuing BABs. They include a reduction in the Federal subsidy amount from 35% to 28%, an increase in the type of eligible issuers to include non-for-profit organizations (healthcare and higher education) and an expansion in the number of eligible uses for issuance proceeds to include current refunding of prior capital projects and funding operating expense (working capital) needs.

The Administration's proposal has had a very positive effect on the BABs market. Making BABs a permanent source of financing for municipalities and expanding the list of eligible issuers and purposes has given the market confidence in the current and future liquidity and supply of the instrument. In addition to the increased breadth and depth of the BABs market, a favorable trend for credit quality upgrades is currently taking place in the municipal bond market which should also support positive performance going forward. These factors in combination with relatively high yields make BABs a very attractive fixed income alternative.

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