Yield Enhancement

for the High Income Executive, Professional Athlete, or Business Owner

CRAWFORD
INVESTMENT COUNSEL
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Municipal bonds typically represent an investor's safest assets or the most conservative component of their portfolio. As such, the yield or expected return on this asset category is fairly modest in nominal terms, but generally offers safety of principal, tax-free income and generally there is some premium over inflation and money market rates of return. Professional asset managers strive to add excess return to tax-free fixed income portfolios without sacrificing their standards for quality or duration. However, few seem to be taking advantage of one of the largest pricing inefficiencies in the high-grade fixed income capital markets.

In our opinion, municipal bonds subject to the Alternative Minimum Tax (AMT) are consistently undervalued and offer considerable value for certain high income investors. It is also our opinion that those who are capable of capitalizing on this fixed income investment vehicle have an opportunity to earn substantially higher yields on their municipal bond investments. Crawford Investment Counsel has been exploiting this inefficiency for the benefit of its clients who fall into the upper tax brackets.

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It is our belief that the reason AMT-subject issues are so attractive is because few bond buyers truly understand them. This leads to lower demand, which in the bond market typically translates to additional yield. In short, the inefficiency exists because the vast majority of buyers of municipal bonds avoid issuers that are subject to the alternative minimum tax out of fear that they (or their clients) will be subject to a 28% tax rate on what is otherwise a tax-exempt bond. While paying tax on a tax-exempt issue is typically not desirable, in many cases the excess yield offered by AMT-subject municipals could lead to a potential superior after-tax yield, even for those investors who do fall into the AMT bracket. However, we believe the real opportunity is for those higher income earners paying marginal tax rates well above the 28% AMT rate.

AMT-subject municipals came into existence in 1986. They are also sometimes referred to as "private activity" bonds. The AMT status is derived from the underlying project that is being financed. For example, if a municipal bond is issued for the purpose of financing an airport or a port improvement, more than likely it will be issued as a private activity bond and interest paid to bondholders will be subject to the AMT, if the bondholder is subject to the tax. It is not the source of the bond guarantor that determines the AMT status, it is the underlying project. For example, if the Port of Houston, Texas issues debt for port improvements, it is AMT subject, even though the debt is guaranteed by Harris County, Texas and is AAA rated.

Over the past ten years, we have seen a substantial increase in the relative value of Alternative Minimum Tax-subject municipals. As more American taxpayers become subject to the tax, many avoid AMT-subject bonds, leading to a favorable price and yield differential for those who have an ability to earn AMT-subject income. It is our belief that this investment is well suited for the individual who has high amounts of ordinary income and is unlikely to be subject to the AMT tax. The relative attractiveness of AMT-subject municipals has been growing. Prior to the financial crisis, the yield spread between AMT-subject municipal bonds versus non-AMT bonds was as little as 25 basis points for intermediate-maturity bonds, or one quarter of a percentage point. The increase in yield has also coincided with a drop in overall interest rates, adding to the relative attractiveness of the relationship. We feel this pick up in yield is significant given today's low interest rate environment. In the current environment for high-quality AAA-rated municipal bonds, an investor can potentially expect yields of approximately 1.20% for a five-year municipal, and 2.50% for a 10-year maturity. If this municipal bond happens to be AMT subject, the yield will can potentially increase as much as a full percentage point. The yield available for the five-year AMT-subject municipal bond of similar quality nearly doubles.

One additional advantage is a possibility for future comprehensive tax reform that eliminates the AMT tax altogether. This could lead to an increase in the value of our investment as the AMT stigma is removed. We would expect the bonds to increase in price as the yield drops to the level of non-AMT subject bonds of the same maturity and quality. In all fairness, we should also point out that an AMT-subject bond will not enjoy the same amount of liquidity as a non-AMT bond. However, we find most investors of short-to-intermediate maturity bonds typically hold them to maturity. Thus the minor lack of liquidity is negated as bonds edge closer to maturity each year. We would also caution the unsophisticated investor from employing this strategy without the assistance of a professional bond manager with expertise in the AMT sector due to the trading nuances of this type of municipal bond.

An individual's AMT status depends on many factors. The tax advisor or CPA has the ability through their high net worth clients' tax plans to identify which high earners have a potential "AMT appetite" and could earn potentially superior tax-free investment returns as a result. For those with a substantial appetite for AMT-sensitive income, this yield enhancement strategy may be appropriate.

At Crawford Investment Counsel, we specialize in many sectors of the municipal market that will potentially enhance our portfolio yield. Our AMT strategy is one of the many tools we utilize to strive to deliver above-market investment returns to both our individual and institutional clients. All of our fixed income strategies utilize separately managed accounts consisting of high-quality, intermediate-maturity securities.

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