

# MONTHLY REVIEW

May 2013

**MAINLINE WEST**

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M U N I C I P A L   S E C U R I T I E S   •   O P P O R T U N I T Y   F U N D S  
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## MUNICIPAL MARKET REVIEW

During the month of May, some fundamental value has returned to the market, thanks to a selloff in US Treasuries. The combination of stronger economic data and Chairman Bernanke's hint that QE may be coming to an end caused yields to increase 20 to 40 basis points. Highlights are as follows:

- Long-term yields increased 35 bps (15 to 25 year bonds), while short-term yields have increased 20 to 30 bps (5 to 10 year bonds).
- Municipal bonds, as we would predict, outperformed the Libor Swap market in a rising rate environment, with rates increasing only 50% to 75% of taxable yields. Yet, this is enough to make municipal investors wary.
- Municipal Market Advisor Default Trends Analysis (data from MMA) shows the pace of defaults in 2013 is ahead of 2012. More specifically:
  - ◇ 23 issuers for a par amount of \$4.99 billion have defaulted as of May 31, 2013.
  - ◇ 31 issuers for a par amount of \$.80 billion had defaulted by this same time last year.
- There continues to be a lot of gossip in DC these days about tax reforms. From our sources, that is about all it is: Gossip! The chances at this point for any reforms having a big impact on munis are minimal.

## INVESTMENT STRATEGY REVIEW

The month of May confirmed our belief in maintaining a defensive strategy during 2013. We are always on the alert for value and opportunities for our investors. The direction of the market over the next couple weeks will be important in framing our outlook for munis this summer, as the supply and demand dynamic plays out.

MUNI ADVISORY

One intriguing aspect of municipal finance is that it brings together parties with different objectives and different time horizons to provide essential services to the public. More specifically:

**Municipalities** borrow funds for **long-term projects** to be funded by the tax dollars/fees of multiple generations.

*Versus*

**Retail Investors** typically invest for only **10 years** in order to minimize market risk.

**Municipalities** try to maintain financing flexibility and desire the opportunity to save debt service costs by **refinancing** when possible.

*Versus*

**Investors** desire to maintain a **stable income** level from their fixed income portfolio.

This inherent imbalance creates an investment opportunity that a long-term municipal bond investor should consider. If an investor is willing to accept some additional market risk and bridge this market imbalance, financial mathematics demonstrates that they will be rewarded over time. Letting the municipal market reward the investor with additional income, while managing risk, offers enhanced returns.

**Introduction:**

A majority of newly issue municipal bonds maturing later than 10 years are embedded with a 10-year call option. This option is exercisable at the discretion of the issuer at any time starting on the first call date, providing the municipality with refinancing flexibility. In most cases, the issuer will exercise this call when it can refinance its debt at a lower interest cost. As a result, the investor faces the proposition of reinvesting in a lower rate environment. **The big question has always been: How does an investor know if the yield they are receiving compensates them for the risk of receiving their investment proceeds at the first called date, final maturity date, or anywhere in between?**

In April, there was a series of bonds issued by the Dallas-Fort Worth International Airport (DFW). This deal had bonds priced with final maturities from 2026 to 2050, coupons of 4.00% and 5.00%, and all with the same first call date of 11/15/2022. This allowed for an excellent opportunity to see how the municipal market prices call risk at different maturities and coupon levels.

**Option Adjusted Spread Analysis (OAS):**

OAS is a common analysis that allows portfolio managers to price the value of a bond after adjusting for the probability it will be called. More specifically, it identifies the basis point spread a bond is earning above and beyond a AAA non-callable bond (with the same maturity), after taking out the cost of call. Another way to look at it is to view it as the credit spread of the bond versus a AAA-rated bond. The higher the OAS, the more yield being earned by the investor that can be associated with credit risk and not call risk. Therefore, in analyzing two bonds from the same issuer, theoretically the OAS (credit risk) should be the same. If they are different, then an investor can assume the value of the call risk between the two bonds has been mispriced, leaving the OAS different between them. When comparing two bonds, the bond with the higher OAS is considered the cheaper bond.

**Data Analysis**
**Dallas Fort Worth Airport - Priced 5/17/13**
**OAS - Calculated w/ Volatility by Maturing Year.**

CUSIP	Cpn	\$ Price	Call Date	Mat Date	YTW (3)	OAS(2)	Vol (1)
235036G38	5.00%	116.20	11/1/2022	11/1/2026	3.01%	71.48	16.23%
235036G46	5.00%	115.75	11/1/2022	11/1/2027	3.06%	69.75	15.19%
235036G53	5.00%	114.35	11/1/2022	11/1/2028	3.22%	75.34	15.19%
235036G61	5.00%	113.39	11/1/2022	11/1/2029	3.33%	79.73	14.72%
235036G79	5.00%	112.96	11/1/2022	11/1/2030	3.38%	79.92	14.57%
235036G87	5.00%	112.36	11/1/2022	11/1/2031	3.45%	83.77	14.17%
235036G95	5.00%	112.10	11/1/2022	11/1/2032	3.48%	84.23	13.89%
<b>235036H29</b>	<b>5.00%</b>	<b>111.68</b>	<b>11/1/2022</b>	<b>11/1/2033</b>	<b>3.53%</b>	<b>82.97</b>	<b>13.62%</b>
235036H78	5.00%	109.83	11/1/2022	11/1/2036	3.75%	96.72	12.87%
235036H60	5.00%	109.58	11/1/2022	11/1/2037	3.78%	96.79	13.74%
<b>235036H45</b>	<b>5.00%</b>	<b>109.41</b>	<b>11/1/2022</b>	<b>11/1/2038</b>	<b>3.80%</b>	<b>99.42</b>	<b>13.90%</b>
<b>235036H94</b>	<b>4.00%</b>	<b>97.76</b>	<b>11/1/2022</b>	<b>11/1/2039</b>	<b>4.14%</b>	<b>81.16</b>	<b>13.75%</b>
235036H86	5.00%	108.34	11/1/2022	11/1/2044	3.93%	97.28	13.76%
235036H52	4.00%	96.13	11/1/2022	11/1/2045	4.22%	<b>80.26</b>	13.76%
235036H37	4.13%	95.86	11/1/2022	11/1/2050	4.35%	94.90	13.76%

**OAS - Calculated w/ Volatility Fixed at 10 Year Maturity Level.**

CUSIP	Cpn	\$ Price	Call Date	Mat Date	YTW (3)	OAS(2)	Vol (1)
235036G38	5.00%	116.20	11/1/2022	11/1/2026	3.01%	69.33	17.87%
235036G46	5.00%	115.75	11/1/2022	11/1/2027	3.06%	65.48	17.87%
235036G53	5.00%	114.35	11/1/2022	11/1/2028	3.22%	70.51	17.87%
235036G61	5.00%	113.39	11/1/2022	11/1/2029	3.33%	73.50	17.87%
235036G79	5.00%	112.96	11/1/2022	11/1/2030	3.38%	72.74	17.87%
235036G87	5.00%	112.36	11/1/2022	11/1/2031	3.45%	75.15	17.87%
235036G95	5.00%	112.10	11/1/2022	11/1/2032	3.48%	74.31	17.87%
<b>235036H29</b>	<b>5.00%</b>	<b>111.68</b>	<b>11/1/2022</b>	<b>11/1/2033</b>	<b>3.53%</b>	<b>75.06</b>	<b>17.87%</b>
235036H78	5.00%	109.83	11/1/2022	11/1/2036	3.75%	84.56	17.87%
235036H60	5.00%	109.58	11/1/2022	11/1/2037	3.78%	84.43	17.87%
<b>235036H45</b>	<b>5.00%</b>	<b>109.41</b>	<b>11/1/2022</b>	<b>11/1/2038</b>	<b>3.80%</b>	<b>88.02</b>	<b>17.87%</b>
<b>235036H94</b>	<b>4.00%</b>	<b>98.92</b>	<b>11/1/2022</b>	<b>11/1/2039</b>	<b>4.14%</b>	<b>61.21</b>	<b>17.87%</b>
235036H86	5.00%	108.34	11/1/2022	11/1/2044	3.93%	85.94	17.87%
235036H52	4.00%	98.30	11/1/2022	11/1/2045	4.22%	53.14	17.87%
235036H37	4.13%	98.27	11/1/2022	11/1/2050	4.35%	83.42	17.87%

**Notes:**

- (1) Volatility calculations provide by TM3 - The Municipal Market Monitor as of 5/20/13.
- (2) OAS calculations generating by Bloomberg
- (3) YTW=Yield to Worst, for 4% coupon this is to the maturity date, for 5% cpn this is the first call date.

**MUNI ADVISORY (CONTINUED)**

When analyzing the results in the above chart, theoretically the OAS (credit spread) should be the same, since all the bonds have the same credit ratings (A+ by S&P, A2 by Moody's). Yet, as the data shows, the OAS's are not the same for all maturities. This means that the yield being paid on the various bonds is not consistent with their call risk and the credit risk. Unless you want to believe that a bond maturing in 2033 (OAS = 82.97) has a lower risk of principal default than the bond maturing in 2038 (OAS = 99.42), then the OAS analysis indicates an investor is receiving an extra 16.45 basis points in yield to invest in the 2038 bond after adjusting for the various potential end dates.

**Assumptions/Disclosures:**

First and foremost, due to the fact that munis are retail driven, the majority of the market does not use OAS analysis when pricing callable bonds. Bonds are priced mainly by supply/demand and what the market will bear. OAS allows an investor to compare bonds with different call provisions and gain insight into the value of the bond after adjusting for call risk. There is no promise that an investor will be compensated for this "value" in the marketplace with better price performance. Yet, it does allow an investor to buy bonds with better call risk value that should provide for better returns over the long-term.

Volatility assumptions are significant in this analysis. This is the forecasted change in rates over time that can lead to a bond being called. OAS analysis is quite sensitive to which volatility measures are used. For the analysis, a 30-day average by maturity, and a 30-day fixed rate for all maturities were used. In the end, the results were a bit different, but the conclusions remained the same.

**Conclusion:**

The results demonstrate that the longer the maturity, the higher the OAS and, therefore, the lower the implied value of the call option. This tells us that the investor gets more value (higher yield after taking out the call risk) by buying a longer callable bond versus a shorter one. We believe this is due to the fact that there is a strong probability, given the current call risk profile of the bond, that it will be called prior to its final maturity. For example, if there is a high probability you are going to have a bond called on 11/15/2022 at par and you can earn either a 3.45% (final maturity of 11/1/2031) or a 3.93% (final maturity of 11/1/2044), why not take on the additional 48 bps of yield and buy the 2044? You are being paid additional yield for a bond that will most likely (according to the financial math) not remain outstanding to its final maturity.

Another observation is that a bond's coupon is a very important factor in calculating the value of a callable bond. The DFW deal allows for a nice comparison of 4% versus 5% coupons. The OAS analysis shows that an investor buying a 4% coupon is not earning enough additional yield for the probability that the bond is not called and makes it to maturity date.

These results are not a surprise to MainLine West, and the DFW deal is not unique to the municipal bond market. It is this type of data that helps support our long-term investment theory of buying maximum maturing premium coupon bonds when the value exists. The investor receives additional yield for owning a 30-year bond, when in most cases the probability of it staying outstanding for the full 30 years is very low. Ultimately, the municipal market is providing the investor additional yield for buying longer maturity bonds, while actively looking to refinance them as soon as possible.

# MONTHLY REVIEW: YIELD & RATE CHANGES

May 2013

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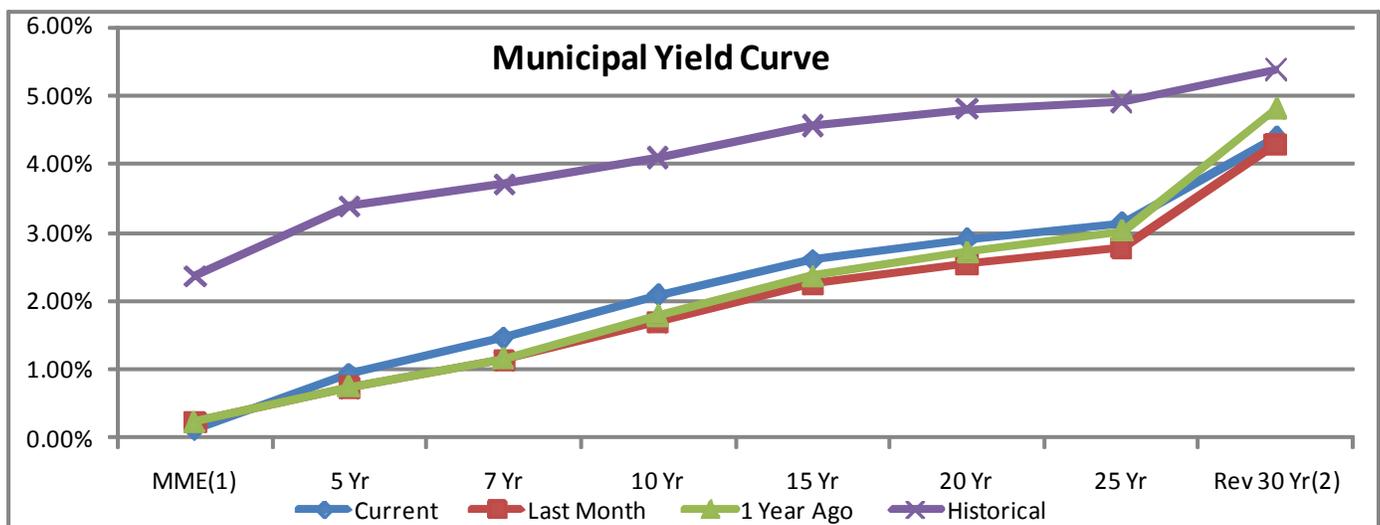
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## TAX EXEMPT & TAXABLE YIELD / RATE LEVELS: 5/31/2013

	AAA Rated Municipal Yields				Libor Swap Market Rates			
	Current	Last Month	1 Year Ago	Historical Avg(3)	Current	Last Month	1 Year Ago	Historical Avg(3)
MME(1)	0.12%	0.23%	0.23%	2.36%	0.19%	0.20%	0.24%	3.33%
5 Yr	0.94%	0.74%	0.75%	3.38%	1.22%	0.81%	0.99%	4.81%
7 Yr	1.47%	1.14%	1.16%	3.70%	1.75%	1.26%	1.31%	5.10%
10 Yr	2.09%	1.69%	1.79%	4.09%	2.31%	1.81%	1.67%	5.37%
15 Yr	2.60%	2.25%	2.36%	4.56%	2.84%	2.35%	2.04%	5.38%
20 Yr	2.90%	2.55%	2.71%	4.80%	3.05%	2.59%	2.18%	5.49%
25 Yr	3.13%	2.77%	3.02%	4.91%	3.16%	2.70%	2.25%	5.49%
Rev 30 Yr(2)	4.39%	4.29%	4.80%	5.38%	3.22%	2.77%	2.23%	5.50%

- (1) MME = Money Market Equivalent: Tax Exempt = 7 day VRDN Rate, Taxable = 1 Month US Libor Rate.
- (2) = Bond Buyer revenue bond index (BBWK25RV). This index mirrors MainLine West's maximum yield strategy. Index represents the yield on 30 year maturing A1 essential service revenue bonds. Index is priced weekly on Thursdays.
- (3) Data from May 1994.



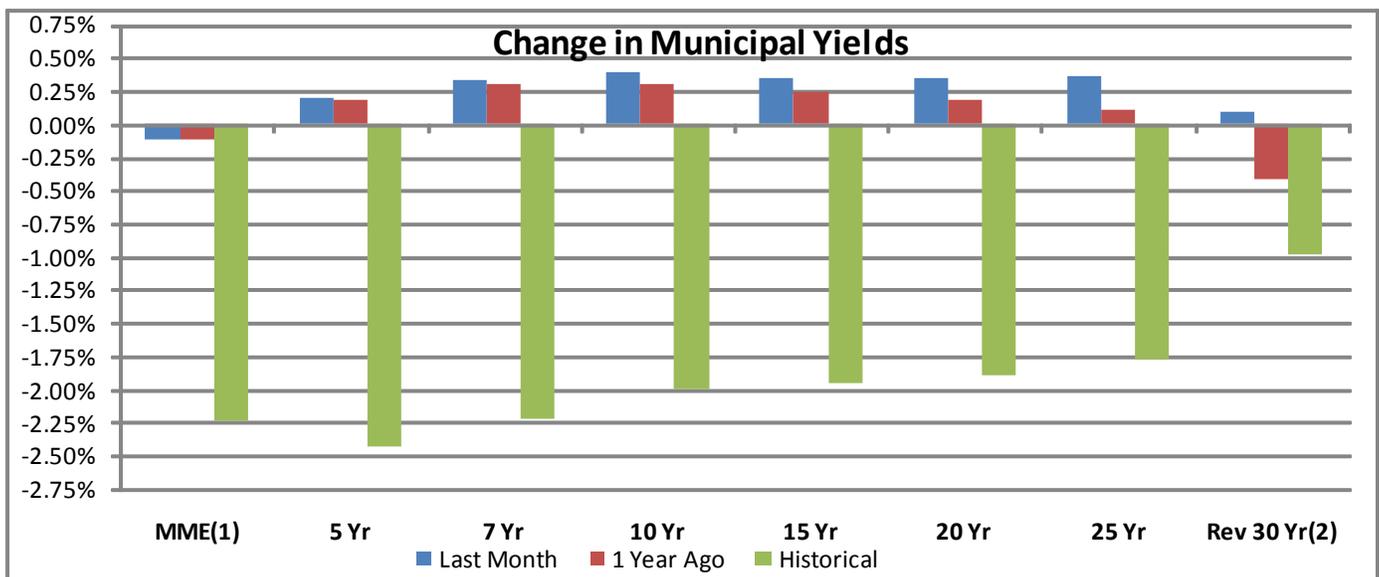
# MAINLINE WEST

MUNICIPAL SECURITIES

OPPORTUNITY FUNDS

## CHANGE IN RATES: 5/31/2013

	AAA Rated Municipal Yields			Libor Swap Market		
	Last Month	1 Year Ago	Historical Avg (3)	Last Month	1 Year Ago	Historical Avg (3)
MME(1)	-0.11%	-0.11%	-2.24%	0.00%	-0.04%	-3.14%
5 Yr	0.20%	0.19%	-2.44%	0.41%	0.23%	-3.59%
7 Yr	0.33%	0.31%	-2.23%	0.49%	0.44%	-3.35%
10 Yr	0.40%	0.30%	-2.00%	0.50%	0.64%	-3.06%
15 Yr	0.35%	0.24%	-1.96%	0.49%	0.80%	-2.54%
20 Yr	0.35%	0.19%	-1.90%	0.46%	0.87%	-2.44%
25 Yr	0.36%	0.11%	-1.78%	0.46%	0.91%	-2.33%
Rev 30 Yr(2)	0.10%	-0.41%	-0.99%	0.45%	0.99%	-2.28%



# MAINLINE WEST

MUNICIPAL SECURITIES

OPPORTUNITY FUNDS

## RATIO MUNICIPAL / LABOR RATES: 5/31/2013

	AAA Rated Municipal Yields			
	Current	Last Month	1 Year Ago	Historical Avg(3)
MME (1)	61.92%	116.16%	96.34%	70.87%
5 Yr	77.05%	91.36%	76.06%	70.27%
7 Yr	84.00%	90.48%	88.55%	72.55%
10 Yr	90.48%	93.37%	107.19%	76.16%
15 Yr	91.55%	95.74%	115.69%	84.76%
20 Yr	95.08%	98.46%	124.31%	87.43%
25 Yr	99.05%	102.59%	134.22%	89.44%
Rev 30 Yr(2)	136.34%	154.87%	215.25%	97.82%

