

Build America Bond Primer

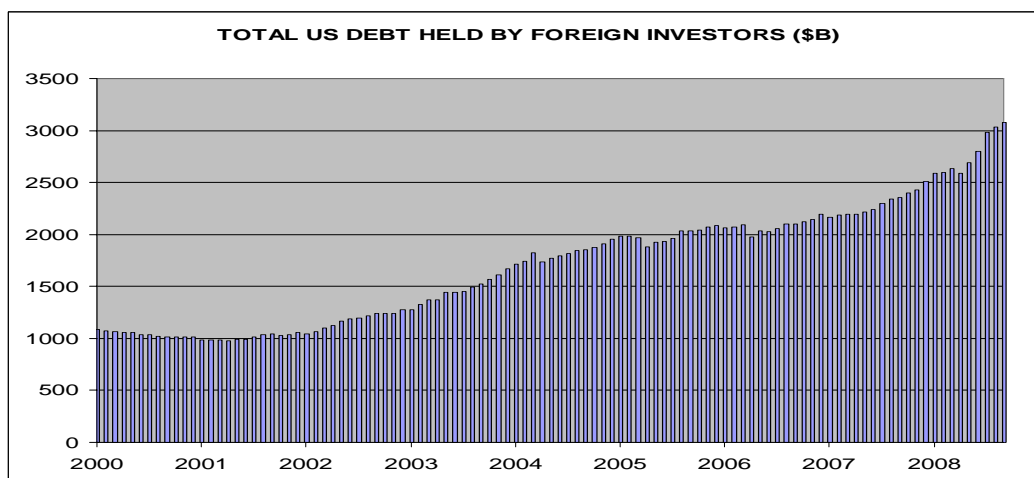


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Build America Bonds, or “BAB’s”, were authorized to be issued by municipalities in early 2009 through the American Recovery and Reinvestment Act. They are federally taxable bonds issued by state and local governments who in turn receive a federal subsidy to make interest payments. Currently that interest subsidy is set at 35%, meaning that the federal government has taken on responsibility of 35% of each interest payment due on all issued bonds. The Treasury has authorized the issuance of BAB’s through the end of 2010 in the attempt to “provide much-needed funding for state and local governments at lower borrowing costs.”(1)

The lower borrowing costs would be realized it was thought, because the universe of potential investors would be greatly increased. Due to the graduated nature of our tax structure, only incomes above 373,650 (3) are subject to the highest federal rate of 35%. Therefore, traditional municipal bonds are attractive to a relatively few number of investors whom are subject to such tax. In the words of the treasury, taxable Build America Bonds are “attractive to investors without regard to their tax status or income tax bracket (e.g., pension funds and other tax-exempt investors, investors in low tax brackets, and **foreign investors**).”(1)

Foreign investment has become a very important source of the Treasury’s own borrowing as can be seen in the amount of overseas ownership of our governments debt, and access to this resource may have been one of the goals behind the program.



Why BAB's Matter

Build America Bonds are authorized through the end of 2010, with no limit to the amount of issuance outside of a few specified issuing authorities. In 2008 taxable bond issuance represented approximately 5.06% of the total municipal supply according to Bloomberg data, by the end of 2009, however, that number had reached \$81 Billion or 21.4%. This occurred despite the Build America Bond program not beginning until mid April of that year. Recent estimates have put the number of taxable municipal issuance, including BAB's at up to \$150 Billion, or nearly twice the issuance of 2009. (5)

How to take Advantage of BABS

Build America Bonds were intended to open the market up to a wider audience of investors, and indeed some of these potential participants stand the largest to gain.

Municipal bonds have historically been a relatively safe investment due to low default rates (see below), and the yields have been attractive to those subject to the highest tax rate. Because these same issuers are now offering taxable debt, investors that are subject to lower tax rates, or those looking to invest within tax exempt accounts, can also take advantage of municipal bonds. In addition, most BAB offerings provide **State Tax Exemption** for those residing in the state of issuance.

Below is a comparison of default rates between similarly rated Municipal and Corporate bonds as compiled by the Municipal Bond Fairness Act.

	<u>MOODY'S</u>		<u>S&P</u>	
	<u>Muni</u>	<u>Corp</u>	<u>Muni</u>	<u>Corp</u>
	<u>Default Rates</u>			
Aaa/AAA	0.0%	0.5%	0.0%	0.6%
Aa/AA	0.1%	0.5%	0.0%	1.5%
A/A	0.0%	1.3%	0.2%	2.9%
Baa/BBB	0.1%	4.6%	0.3%	10.3%
Ba/BB	2.7%	19.1%	1.7%	29.9%
B/B	11.9%	43.3%	8.5%	53.7%
Caa-C/CCC-C	16.6%	69.2%	44.8%	69.2%
Investment Grade	0.1%	2.1%	0.2%	4.1%
Non-Invest Grade	4.3%	31.4%	7.4%	42.4%
All	0.1%	9.7%	0.3%	13.0%

A good comparison between traditional tax-exempt bonds and taxable BAB's can be found in examples of recent issues that have come in both forms. In early December 2009 Louisville and Jefferson County KY issued \$200M of Aa1/AAA Water Rev bonds. Roughly half of the bonds issued were traditional tax exempts, the other half were BAB's.

Looking at non call bonds maturing 11/15/2020 we can see that the tax exempt bonds were priced to yield 3.10% while the taxable BAB's were priced to yield 4.60%. For most investors in taxable accounts the tax exempt bonds would return a better rate after taxes, however, in tax exempt or advantaged accounts the taxable BAB bonds can offer a significant advantage. In addition to the extra 150bps of yield, an investor can realize potential appreciation in bonds without regard to tax consequences.

Because of the disparity between default rates of municipals vs similarly rated corporate bonds as previously mentioned, comparisons to other taxable instruments can be a little more difficult, but nonetheless revealing.

Using the previous Louisville KY example, taxable bonds maturing in 2019 were issued at 4.35%. On that day AAA/AAA Microsoft 4.20% of 6/1/19 were trading at around 3.85%. The 10-year was approx 3.45. This equates roughly to spreads of 40bps and 90bps respectively.

So, what accounts for the extra 50bps of yield an investor would receive from Louisville KY than they would get from Microsoft? Certainly one reason is that BAB's simply do not have the same familiarity and number of investors as corporate bonds, thus reducing demand. Another is that the structure of the bonds results in a less liquid market going forward. MSFT issued all its debt (1Billion) in a single maturity, while the KY deal is spread over multiple years, reducing the number of outstanding bonds per maturity.

Going Forward

Taxable BABs have been a major player the municipal space over the past 9 months and are poised to be a dominant player for at least the next year to come. Bonds currently issued and those coming to market throughout the year will have a 35% interest subsidy to maturity, despite potential changes to the BAB program at the end of 2010.

Build America Bonds can provide relatively safe income to investors in tax advantaged accounts or to those investors subject to lower tax rates. In addition, most taxable municipals provide state exemption to those residing in the state of issuance.

We believe that the Build America program will offer clients of Oppenheimer opportunities to improve the overall return of their portfolios while maintaining a lower level of risk as compared to traditional taxable fixed income products.

Contact Oppenheimer's Taxable Municipal Desk in Chicago at 312-360-5957 for offerings or questions.

Sources:

Build America From Treasury (1)

<http://www.ustreas.gov/press/releases/docs/BuildAmericaandSchoolConstructionBondsFactsheetFinal.pdf>

Link to foreign investment

<http://www.treas.gov/tic/mfhhis01.txt>

TaxBrackets(3)

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Default rates Muni Bond fairness (4)

http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=110_cong_reports&docid=f:hr835.110

Issuance Estimates (5)

<http://www.bloomberg.com/apps/news?pid=20601109&sid=a1KEruW.uYmo>

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