# A COMPARATIVE ANALYSIS:
# TAXABLE MUNICIPAL BONDS AND CORPORATE BONDS

COMMUNITY
CAPITAL
MANAGEMENT
*Revitalizing America*

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## HYPOTHESIS:

A traditional balanced investment strategy of equity and fixed income securities can produce unexpected positive correlation of returns and excess volatility. ***Allocation to corporate bonds in both passive and active fixed income strategies exposes investors to the same cyclical factors that impact their equity holdings.*** Correlation may be reduced by decreasing corporate credit exposure in favor of taxable municipal bonds, which often possess comparable income and credit quality with lower volatility and correlation of returns.

## Introduction

This white paper will identify an opportunity for investors to mitigate exposure to the corporate capital structure by investing in taxable municipal bonds. We will discuss how excessive exposure to the corporate bond sector reduces the diversification benefits of fixed income securities. This point becomes evident as we explore the correlation coefficients between major indices and core fixed income managers over a five-year time horizon and during periods of extreme market volatility (2008 and 2009). We then take a closer look at how the referenced indices and many core fixed income managers are more positively correlated to the equity market when equities produced negative returns — periods in which the investor would normally expect their fixed income allocation to mitigate portfolio losses. We further support the inclusion of taxable municipal bonds in a balanced portfolio as we compare the sector's standard deviation to that of the corporate debt sector. In the following pages, we will show how taxable municipal bonds have exhibited a substantially lower standard deviation during heightened volatility (2008 and 2009), as well as over the four-year period ended March 31, 2010. Finally, we provide a brief overview of both sectors' credit profiles by analyzing average credit exposure, cumulative default rates, and ratings stability.

## Potential Flaws in Balanced Portfolios

A fundamental theory of portfolio management is to determine the appropriate asset allocation in proportion to the investors' risk tolerance, and then select and monitor suitable investments on an ongoing basis. Asset allocation enables investors to diversify among different investment categories to reduce risk. This balanced portfolio approach is specifically designed to provide both income – generally from intermediate-term investment grade fixed income securities – and capital appreciation from shares of common stock.

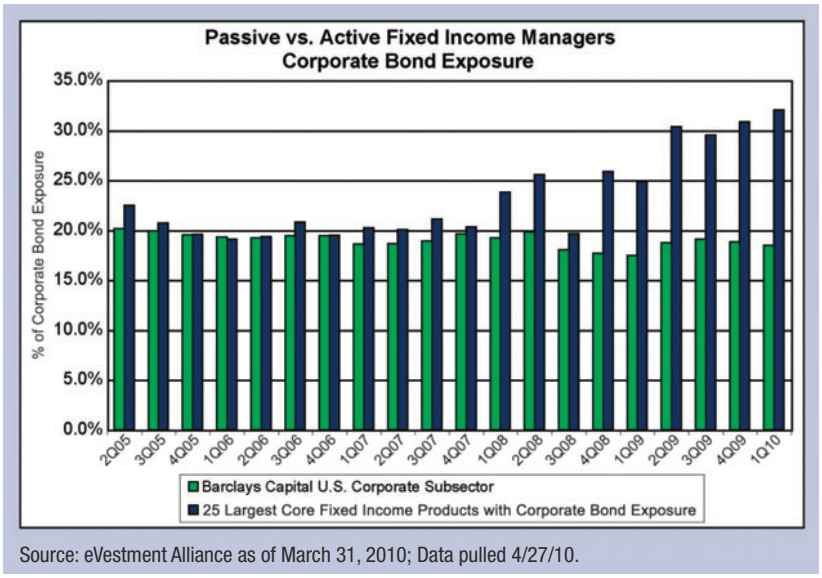


*Exhibit 1: The 25 largest Core Fixed Income products reporting corporate bond exposure.*

Due to their perceived lower risk and lower correlation to equities, investment grade bonds are traditionally used as a hedge against equity positions in balanced portfolios. However, investors may be exposing themselves to far greater fluctuations in returns since their portfolio will have higher exposure to the corporate capital structure than intended.

Actively managed core fixed income portfolios tend to overweight corporate bond exposure relative to the Barclays Capital U.S. Aggregate Bond Index (Barclays Aggregate) to achieve higher portfolio yield. For example, at the end of the first quarter 2010, the 25 largest Core Fixed Income products reporting corporate bond exposure had an allocation of 32.0% to corporate bonds, compared to the Barclays Aggregate which had an 18.5% allocation to corporate bonds (Exhibit 1). For the five-year period, the 25 largest Core Fixed Income products reporting corporate bond exposure had an average weighting of 23.3% to corporate bonds. For the same time period, the Barclays Aggregate's corporate bond exposure was 19.0%. This is an approximate overweight of 22.5% (Exhibit 1) which shows how active investment strategies can exhibit less diversification away from the corporate credit structure than perhaps otherwise acknowledged.

*Excessive exposure to the corporate bond sector reduces the diversification benefits of fixed income securities.*

## Negative Diversification Effects

This overexposure to the corporate capital structure can produce unintended and negative diversification effects in balanced portfolios over the longer term. For example, for the five-year period ended March 31, 2010, the Barclays Aggregate was positively correlated to the S&P 500, the primary stock market benchmark, with a correlation coefficient of 0.22 (Exhibit 2). Active fixed income portfolios, as measured by Morningstar's Intermediate-Term Bond Category ("Morningstar") and the eVestment Alliance Core Fixed Income Universe ("eVestment Alliance"), were more positively correlated to stocks during this time period, with correlation coefficients of 0.55 and 0.32, respectively. Balanced portfolio strategy theorizes that fixed income allocations should insulate investors' portfolios against erratic swings up or down in the equity markets. However, this positive correlation for both actively- and passively-managed bond portfolios *limited* the anticipated diversification benefits of investors' allocation to bonds.

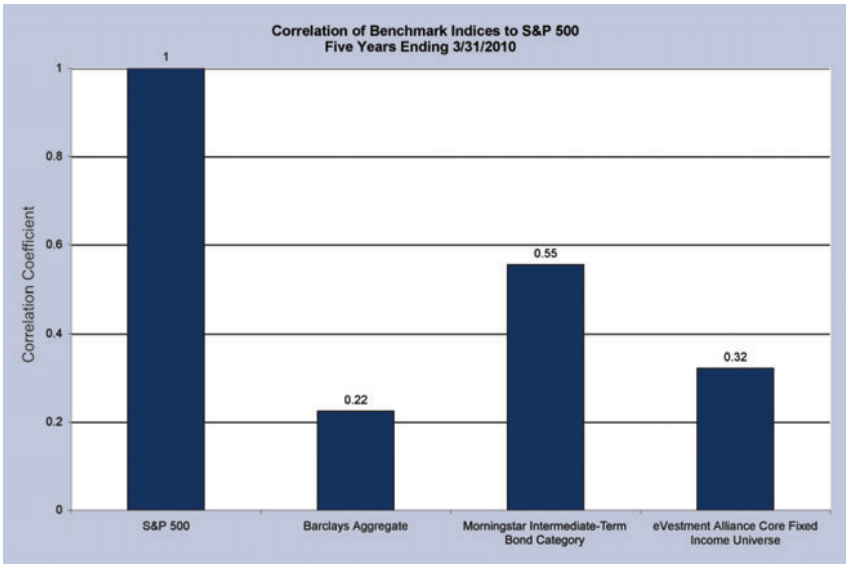


*Exhibit 2: Both actively- and passively-managed bond portfolios exhibited a positive correlation coefficient to equities for the five-year period ended 3/31/10, thereby limiting the anticipated diversification benefits of investors' allocation to bonds.*

This positive correlation is even more prevalent during time periods when stocks produced negative returns. As illustrated in Exhibit 3, during the months when stocks produced negative returns over the past five years, active and passive fixed income portfolios were even more *highly correlated* with equities.

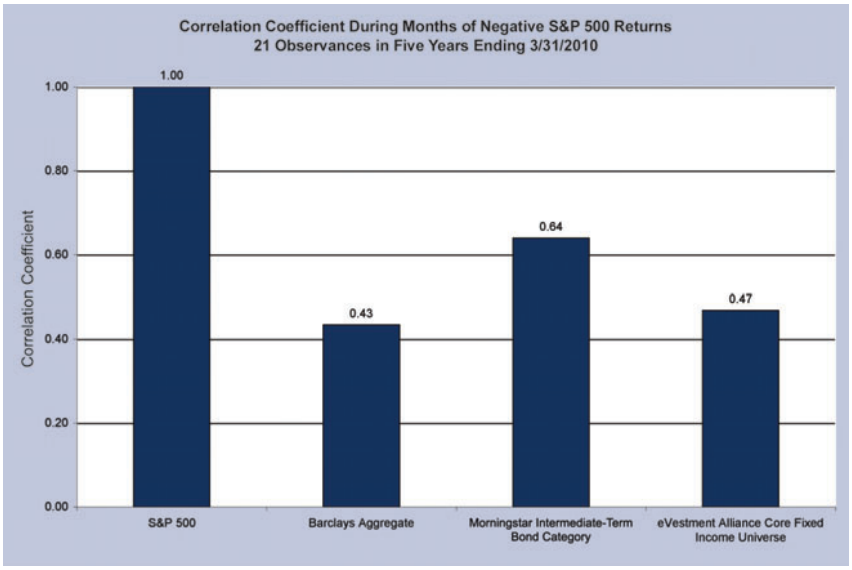


*Exhibit 3: When stocks were negative, both actively- and passively-managed bond portfolios exhibited higher correlation, providing less diversification benefits from their bond portfolios.*

## Negative Diversification Effects During Periods of Extreme Market Volatility

In periods of extreme volatility, such as 2008, the negative diversification effects of an increased exposure to corporate bonds in a balanced portfolio is even more pronounced. In 2008, active fixed income managers (as measured by Morningstar's Intermediate-Term Bond Category) returned an average of negative 4.9% with a positive correlation coefficient of 0.62. During the same period, the S&P 500 returned negative 37.0% (Exhibit 4).

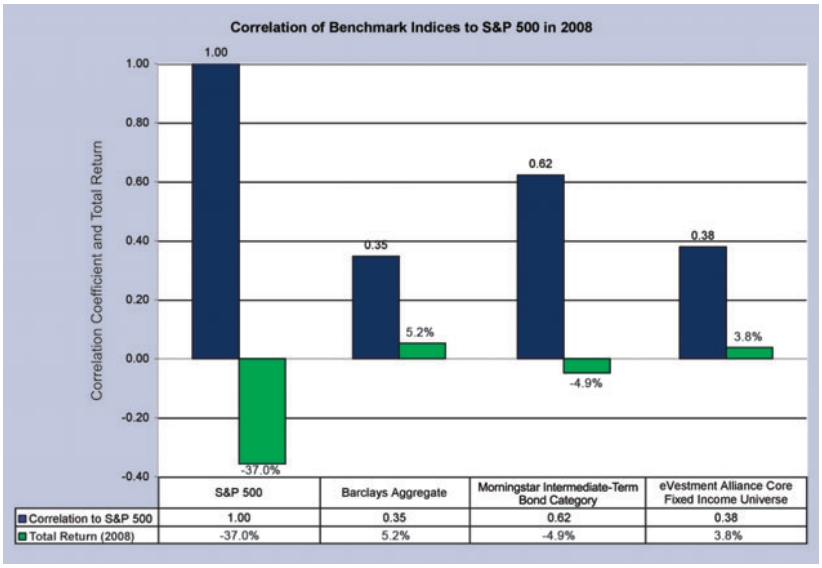


*Exhibit 4: Overexposure to corporate bonds led to negative diversification effects in 2008, a period of extreme market volatility.*

Following the near collapse of the financial markets in 2008, the markets reversed course in 2009. Equities rebounded sharply, posting total returns of 26.5% at year-end. Likewise, corporate bonds ended the year up 18.7%. Bond portfolios that were highly correlated to stocks boded well from a total return perspective when equities posted such strong performance in 2009. For example, Morningstar's Intermediate-Term Bond Category had total returns of 14.0% with a positive correlation coefficient of 0.76 (Exhibit 5).

Thus, an increased weighting in corporate bonds can lead to heightened volatility when investors need to rely more heavily on their fixed income allocation to hedge against downturns in the equity markets. This can decrease the effectiveness of an investor's fixed income allocation and in turn, hinder a balanced portfolio's returns over the longer term.

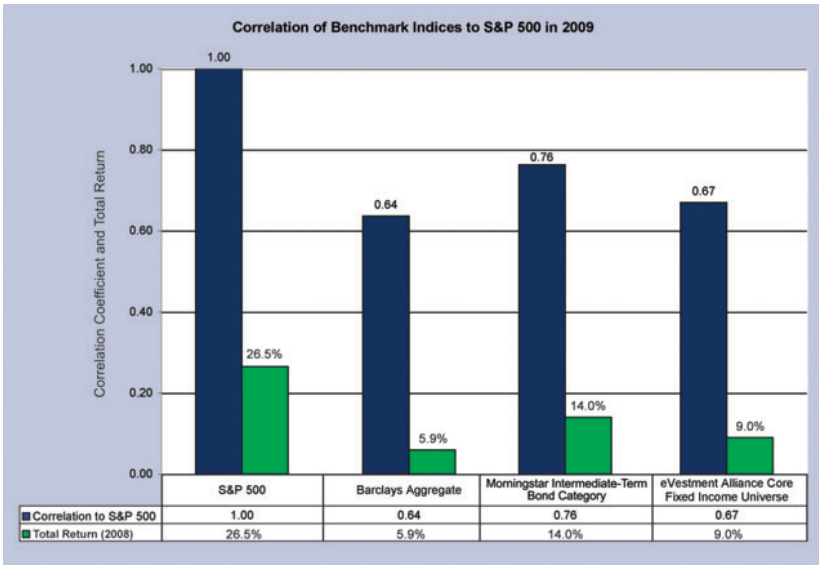


*Exhibit 5: Overexposure to corporate bonds led to even higher positive correlation in 2009, a period of extreme market volatility.*

## Taxable Municipal Bonds

Taxable municipal bonds, a traditionally overlooked sector of the market, are an ideal substitute to corporate bonds in a core fixed income strategy. Taxable municipal bonds are taxable debt obligations issued by a state or local government entity, an outgrowth of the tax reform act of 1976 (which restricted the issuance of traditional tax-exempt securities). Taxable municipal bonds are subject to federal taxes, but in some instances are exempt from state and local taxes. In 2009, Build America Bonds (BABs) were introduced by the Obama Administration as part of the American Recovery and Reinvestment Act to provide needed capital to state and local governments at lower borrowing costs. Under the BAB program, a federal subsidy of 35% is available on a taxable bond's interest payments.

| Issue Date | Matry | Description | Size(mm) | Rating (Moody) | Issue YTM | Current YTM | Comp. Corp. YTM | Pickup |
|---|---|---|---|---|---|---|---|---|
| 4/22/2009 | 30rys | CA TXB-VAR PURP | $3,000 | A/Baa1 | 7.43% | 7.78% | 6.33% | +145bps |
| 8/11/2009 | 29 | CHICAGO WTR TXB-BAB | 600 | AAA/Aaa | 5.72 | 5.59 | 5.50 | +9 |
| 04/20/09 | 30 | NJ TPK -F-TXB | 1,375 | A+/A3 | 7.41 | 6.14 | 5.84 | +30 |
| 2/4/2010 | 29 | MTA NY-TXB | 251 | AA/A+ | 6.65 | 6.23 | 5.84 | +39 |

Source: Bloomberg, CIRA

*Exhibit 6: Yields of selected large BAB deals vs. yields on non-financial corporate comparables[1] (yields as of March 5, 2010).*

Taxable municipal bonds, including BABs, offer yields more comparable to those of other taxable sectors, such as corporate bonds or bonds issued by U.S. governmental agencies, than to those of tax-exempt municipal bonds.

Their absence or extremely small weighting in any major bond index provides opportunities for bond investors to increase income versus the Barclays Aggregate. For example, Exhibit 6 compares average yields on selected Build America Bonds to mid- to long-maturity non-financial corporate bonds with similar credit ratings. Certain BAB deals may provide significant pickups to corporate bond yields.

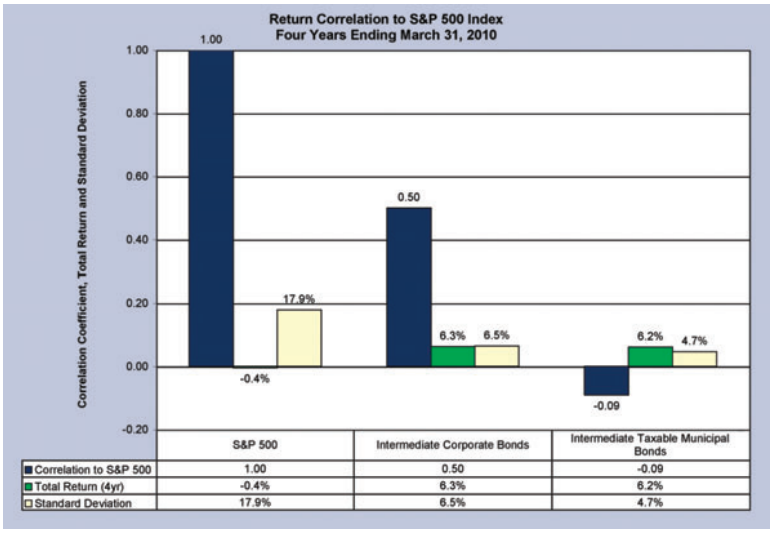


*Exhibit 7: Taxable municipal bonds offer greater diversification benefits with a much lower volatility and similar returns over a five-year period.*

Taxable municipal bonds offer greater diversification to equity returns compared to corporate bonds, while exhibiting lower volatility and similar returns. For the four-year period ended March 31, 2010, the volatility of returns (standard deviation) for taxable municipal bonds, as measured by the Intermediate-Term portion of the Barclays Capital Taxable Municipal Bond Index, was 4.7% compared to 6.5% for corporate bonds, as measured by the Intermediate-Term portion of

[1] Average yield of non-financial corporate bonds within CITI BIG index that mature in more than 10 years and have similar rating as stated BAB

the Barclays Capital Corporate Bond subsector. Total returns for taxable municipal bonds were 6.2% versus 6.3% for corporate bonds, an underperformance of 10 basis points or just 2% versus the increased volatility of approximately 40% for the same time period (Exhibit 7).

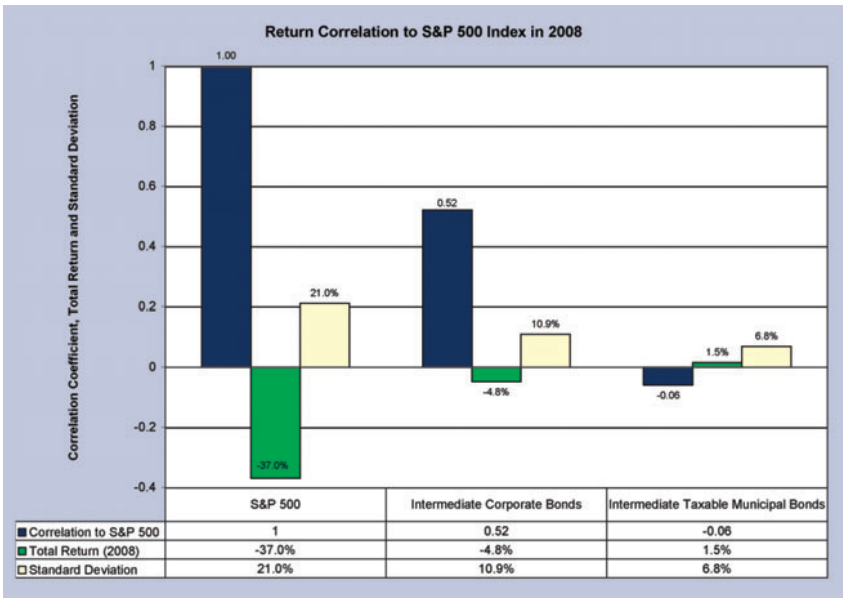


*Exhibit 8: Taxable municipal bonds offer greater diversification benefits in times of extreme market volatility as evidenced in 2008.*

In 2008, taxable municipal bonds exhibited a correlation coefficient of -0.06 and standard deviation of 6.8% versus a positive correlation coefficient of 0.52 and standard deviation of 10.9% for corporate bonds. From a total return standpoint, taxable municipal bonds produced positive returns of 1.5% and corporate bonds returned negative 4.8%, magnifying the correlation of corporate bonds to the corporate capital structure (Exhibit 8). During this period of extreme market volatility, taxable municipal bonds would have been an enhancement over corporate bonds to reduce volatility in a core fixed income portfolio. Passive asset allocation models tied to benchmark bond indices would have led investors to excess exposure to the corporate credit sector.

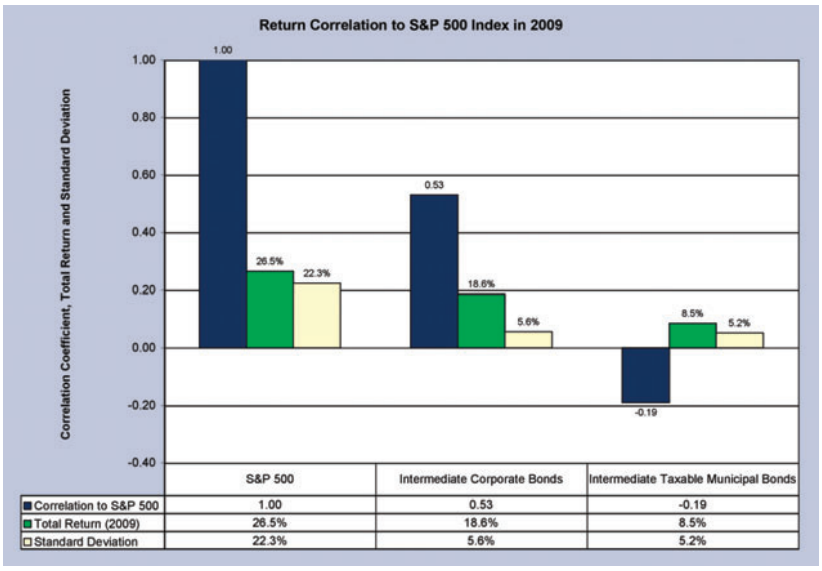


*Exhibit 9: Taxable municipal bonds offer greater diversification benefits in times of extreme market volatility as evidenced in 2009.*

In 2009, when the risk trade reversed and there was a flight from quality, corporate bonds returned 18.6% as equities rose nearly 26.5%. Taxable municipal bonds continued to exhibit a lower correlation coefficient and less volatility compared to corporate bonds returning approximately 8.5% (Exhibit 9).

## Recent Trends

Since the inception of the Build America Bond Program, more than $90 billion in local and state bond issues have helped stabilize the municipal credit markets. Several BABs have already been included in the Barclays Aggregate and helped spur taxable municipal issuance to $78.8 billion in 2009 from $25.9 billion in 2008.[2]

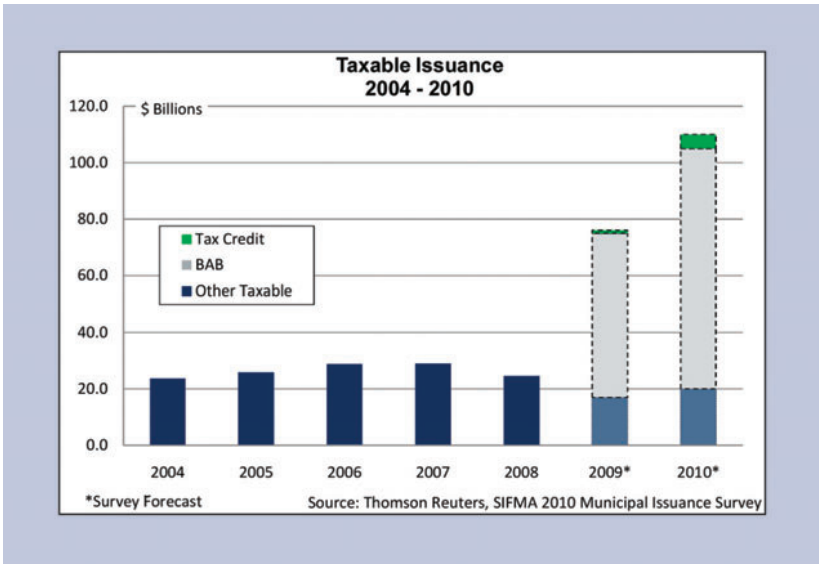


*Exhibit 10: Taxable issuance is expected to jump by 45% in 2010.*

The SIFMA 2010 Municipal Issuance Survey forecasts total taxable issuance to jump by 45% in 2010 due to the introduction of several new taxable bonds in 2009, such as BABs. Suvey respondents also anticipate a significant rise in tax credit municipal issuance, particularly for tax credit BABs[3] (Exhibit 10). Pending the expected extension of the BAB program through April 1, 2013, the supply of taxable municipal bonds is likely to continue to grow. In addition, as crossover buyers have become more active in this sector, credit spreads have tightened which will ultimately lower the borrowing costs for municipalities.

*The SIFMA 2010 Municipal Issuance Survey forecasts total taxable issuance to jump by 45% in 2010 due to the introduction of several new taxable bonds in 2009, such as Build America Bonds.*

[2] Source: Securities Industry and Financial Markets Association (SIFMA) Research Report Fourth Quarter 2009

[3] The survey was conducted from November 9 – November 30, 2009. The forecasts discussed in the text and appearing in the accompanying data tables are the median values of the individual member firms' submissions, unless otherwise specified.

## Credit Quality Considerations

Within an active fixed income portfolio, corporate bonds are often added to increase incremental income in the portfolio. In addition, investors may reach further out on the credit curve to maximize yield. From a credit perspective, municipal bonds exhibit a stronger credit profile than their corporate counterparts. In a study conducted by Standard and Poor's (S&P) on the 15-year average cumulative municipal and corporate default rates, all rated bonds had cumulative default rates of 0.2% for municipal securities versus 12.6% for corporate securities (Exhibit 11).

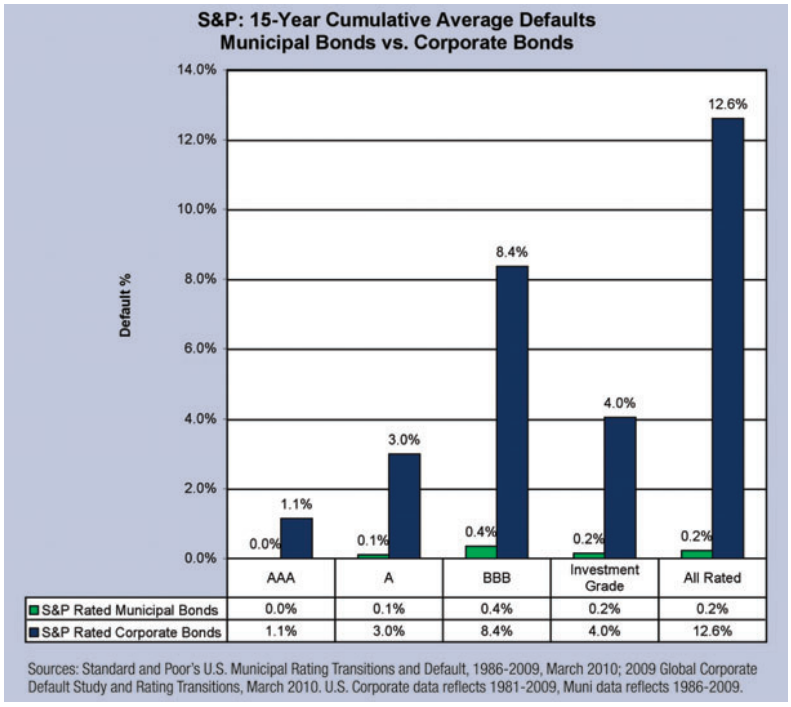


*Exhibit 11: Municipal bonds have exhibited a stronger credit profile than their corporate counterparts.*

A recent report published by Citi Investment Research & Analysis (CIRA) showed that in 2008 and 2009, only 27% of Aaa-rated municipal bonds which experienced a ratings transition were either downgraded or defaulted. This compares to 86% of Aaa-rated corporate bonds over the same time period (Exhibit 12).

In the near term, we anticipate the potential for downgrades within municipal and taxable municipal credit markets given the continued economic and recessionary woes facing state and local governments. However, despite these economic effects, municipal credits, including taxable bonds, still offer investors tremendous opportunity when evaluated appropriately.

**Decomposition of Ratings Transitions, 2008-2009**

| | Percent of bonds experiencing transitions | | Percent of transitions which were upgrades[2] | | Percent of transitions which were downgrades and defaults[2] | |
|---|---|---|---|---|---|---|
| | Muni | Corp | Muni | Corp | Muni | Corp |
| Aaa | 10.17% | 32.98% | n/a | n/a | 27.14% | 85.90% |
| Aa | 4.5 | 27.07 | 3.56% | 0.00% | 31.33 | 83.71 |
| A | 6.48 | 17.78 | 18.67 | 4.33 | 14.81 | 63.50 |
| Baa | 13.08 | 15.37 | 24.92 | 9.24 | 7.19 | 47.89 |
| Ba | 24.66 | 29.36 | 27.98 | 11.96 | 29.16 | 56.85 |
| B | 39.7 | 33.55 | 20.25 | 8.23 | 55.06 | 69.84 |
| Caa-C | 28.15 | 38.96 | 0.00 | 10.99 | 47.4 | 67.94 |

[2] Ratings transitions include upgrades, downgrades, defaults and transition to withdrawn rating (WR), so upgrades, downgrades and defaults will not sum to 100% of transitions.

Source: CIRA, Moody's

*Exhibit 12: In 2008 and 2009, only 27% of Aaa-rated municipal bonds which experienced a ratings transition were either downgraded or defaulted.*

## Conclusion

Many investors underestimate their total exposure to the corporate capital structure given their allocation to corporate bonds in conjunction with equity weightings. Even investors using the Barclays Aggregate as a model for their asset allocation (i.e., passive investing) can be negatively impacted.

Relative to corporate bonds, taxable municipal bonds have historically offered: *similar returns, higher credit quality and most importantly, lower volatility and greater diversification*. As part of a balanced portfolio, the taxable municipal bond market can offer investors an ideal surrogate to corporate bonds.

## Glossary*

**Balanced Portfolio** – A method of portfolio allocation designed to provide both income and capital appreciation while avoiding excessive risk.

**Barclays Capital Taxable Municipal Index** – Represents a rules-based, market-value weighted index engineered for the long-term taxable bond market. For inclusion in the Index, bonds must be rated investment-grade quality or better, have at least one year to maturity, have a coupon that is fixed rate, have an outstanding par value of at least $7 million, and be issued as part of a transaction of at least $75 million. The Intermediate Municipal subsector groups together securities with an average maturity between one to 10 years. The index has historical data to January 2006.

**Barclays Capital U.S. Aggregate Bond Index** – Represents securities that are SEC-registered, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. For inclusion in the Index, securities must be rated investment-grade quality or better, have at least one year to maturity, have a coupon that is fixed or changes according to a predetermined schedule and have at least $250 million par amount outstanding. The primary subsectors of the Index are:

**U.S. Credit** – Publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered. This includes the U.S. Corporate subsector and Non-Corporate subsector. The Intermediate Corporate subsector groups together securities with an average maturity between one to 10 years.

**U.S. Government** – Securities included are those issued by the U.S. Government and include: public obligations of the U.S. Treasury with a remaining maturity or one year or more; publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government.

**U.S. Securitized** – Comprised of:
*U.S. Mortgage-Backed Securities (MBS)* - Mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC). The MBS Index is formed by grouping the universe of over 600,000 individual fixed rate MBS pools into approximately 3,500 generic aggregates.
*Asset-Backed Securities* – Credit and charge cards; autos; and utility subsectors. Securities must be investment grade, fixed rate with an average life of at least one year. Minimum deal size of at least $500 million and $25 million tranche size.
*Commercial Mortgage-Backed Securities* – Investment grade securities with a minimum deal size of $500 million and a minimum tranche size of $25 million. Collateral for each transaction must be new origination, originated specifically for securitization and transactions must be private label; agency transactions are excluded.

**Correlation Coefficient** – A correlation coefficient is a number between -1 and 1 that measures the co-movement (linear association) between two random variables. The lower the correlation coefficient, the greater the diversification benefits.

**eVestment Alliance Core Fixed Income Universe** – All fixed income products that invest in High Quality Debt (as rated by Moody's or Standard & Poor's). Managers in this category will typically indicate a "Fixed Income Style Emphasis" equal to Core and a "Product Duration Emphasis" equal to Core or Intermediate.

**Morningstar's Intermediate-Term Bond Category** – A category of funds that focus on corporate, government, foreign or other issues with an average duration of greater than, or equal to 3.5 years but less than or equal to six years, or an average effective maturity of more than four years but less than 10 years.

**Standard & Poor's (S&P) 500** – The S&P 500 is an index of 500 of the most widely held stocks on the New York Stock Exchange.

**Standard Deviation** – A measure of the average deviations of a return series from its mean; often used as a risk measure. A large standard deviation implies that there have been large swings or volatility in the manager's return series.

*Source: Barclays Live; CFA Institute; eVestment Alliance; and Morningstar.

## ABOUT COMMUNITY CAPITAL MANAGEMENT, INC.

Established in 1998, Weston, Florida-based Community Capital Management is a fixed income manager and a registered investment adviser with the SEC whose goal is to produce above-average, risk-adjusted returns, capitalizing on its expertise within government-related subsectors of the bond market traditionally excluded from the major bond indices.

Clients may also elect to use one or more optional secondary screens designed to identify bonds that target: a predefined geographic area; a specific set of community and/or economic development initiatives (e.g. "green" or "sustainable" design); and minority neighborhoods (defined by census tract data).

For more information, please visit www.ccmfixedincome.com or call 877-272-1977.

*This white paper reflects the analysis and opinions of Community Capital Management as of May 2010. Because market and economic conditions are often subject to rapid change, the analysis and opinions provided may change without notice. The analysis and opinions may not be relied upon as investment advice. References to particular securities, or types of securities, are only for the limited purpose of illustrating general market or economic conditions, and are not recommendations to buy or sell a security or an indication of the Community Capital Management's holdings on behalf of its clients. Statements of fact are from sources considered reliable, but no representation or warranty is made as to their completeness or accuracy. Although historical data is no guarantee of future results, these insights may help you understand our investment management philosophy. All investments are subject to certain risks. This publication is for investors and investment consultants interested in the products available through Community Capital Management and its affiliates. Various account minimums or other eligibility qualifications apply depending on the investment strategy or vehicle. Diversification does not guarantee a profit or protect against loss.*

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