TCW Insight that works for you.™

METWEST

February 24, 2010

Mike Carrion
Corporate Trader
U.S. Fixed Income

Build America Bonds: Overview and Update

The Build America Bond (BAB) program, authorized by Congress as part of the American Recovery and Reinvestment Act of 2009, has led to a rapid expansion and broadening of the taxable municipal bond market. BABs are taxable municipal bonds that are effectively subsidized by the Federal government. As such, the program was designed to provide municipalities, particularly those with stressed financials, an attractive and alternative means to tap the capital markets.

The Federal "subsidy" can technically come in either of two forms, though as a practical matter all issuance to date has tapped the first of these two approaches:

1. **Direct Subsidy:** Municipal issuer receives an ongoing subsidy from the Treasury equal to 35% of the interest payment due on the bond for the life of the security.

2. **Credit to Bondholders:** A bondholder is able to claim a credit equal to 35% of the interest payment due on the bond for the life of the security. Hence, the bondholder is able to directly offset earned income.

Fundamentals

The fundamental credit analysis of taxable munis/BABs is little different from what is required for tax-exempt munis. For state General Obligation (GO) debt, the analysis centers on examining the "sovereign" credit of a state such as California or Illinois. As such, one looks to population size and growth, income levels compared to national averages, major employers and industries, political stability, and debt ratios such as debt per capita and debt as percentage of income. Since it is ultimately the ability of the state to raise taxes that matters for the bondholder, an assessment of the state government's flexibility in this regard is paramount.

Also of fundamental consequence is where payments to bondholders stand in the "waterfall" of cash flows available to the state. For instance, in California the state constitution (which theoretically could always be amended) specifies that payments for primary/secondary education are at the top of the waterfall in terms of priority, followed by interest payments to bondholders. Significantly, while no state has actually reneged or restructured its debt, we are not aware of any provisions under Federal bankruptcy statutes that facilitate redress against a state government that does default. Consequently, the systemic importance of a state to the national economy and centrality of its debt in the muni markets is also of crucial importance in evaluating a state GO.

With revenue bonds, the analysis tends to focus on the revenue earned by the issuing entity. The local economy and employment trends are important as are debt service coverage ratios and the position the note payments fall in the issuer's "capital structure." As with state GO debt analysis, the extent to which the services provided by the entity are essential need to be analyzed.

"TCW finds attractive opportunities in this space in select state GO and revenue bonds relative to investment grade corporates."

Similarities exist when doing a compare and contrast between municipalities and regulated utilities. A municipality typically is bound by legislation to balance its budget each year. When faced with a budget deficit, the municipality's choices are to (i) raise revenue (i.e. taxes) or (ii) cut expenses. Fortunately for the bondholder, many municipalities can unilaterally increase taxes or rates to augment revenues.

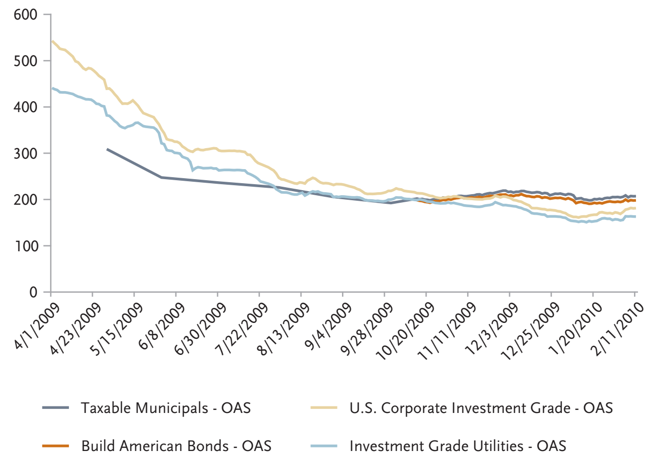
Similarly, utilities' business models are "cost-plus" based and, as such, often have the ability to increase rates (once approved by PUCs) as compensation for increased variable or capital costs. In neither instance does the customer (i.e. taxpayer or ratepayer) have direct input into the process. In that regard, the business models are creditor friendly.

Relative Value/Liquidity

For most of 2009, taxable munis underperformed Treasuries with Q4 underperformance of -1.69%. In contrast, corporates outperformed Treasuries by 3.07% in Q4. This underperformance was a result of the massive issuance in the sector and strained finances of municipal issuers. Supply during 2009 was approximately $7 billion in new issuance per month and is projected to increase by 40-60% y-o-y during 2010. Even so, taxable munis have remained reasonably well bid despite the widening in the broader credit/sovereign markets over the past few weeks.

YTD spreads are 5-15 basis points tighter, with notable exceptions being California and Illinois 30-year GOs which are 5-10bp wider. These two issuers account for 16% and 17% respectively of the taxable muni index. At the beginning of January, the OAS for the taxable muni index was 40bp higher than investment grade corporates, the widest since the initiation of the of the BABs program. TCW finds attractive opportunities in this space in select state GO and revenue bonds relative to investment grade corporates.

Taxable Municipals vs. Investment Grade Corporates



Source: Barclays

And while liquidity is not as robust as it is within the on-the-run investment grade corporate universe, it has improved with increased BAB issuance. Taxable munis account for 2.2% of the Credit index and 7.5% of the Long Credit index and Barclays expects these weightings to increase to 4.6% and 17.5% respectively by the end of 2010.

METWEST IS A WHOLLY OWNED SUBSIDIARY OF THE TCW GROUP, INC.
865 South Figueroa Street | Los Angeles, California 90017 | 213 244 0000 | www.tcw.com