MUNICIPAL BOND INVESTING

TAKING ADVANTAGE OF AN INEFFICIENT MUNICIPAL MARKET

Actively managed muni funds may offer benefits in changing markets

Ongoing market stress and volatility have kept investors searching for effective ways to manage portfolio risk and maximize income while keeping an eye on potential tax exposure.

In efficient markets, passive investing typically is most effective. But inefficient markets call for different strategies. Now more than ever, an active management approach – such as through municipal bond funds – may make better sense for your portfolio.

UNUSUAL MARKET CONDITIONS

For the municipal bond market – usually considered inefficient compared to segments of the stock and Treasury bond markets – a confluence of events has created conditions unlike any that have occurred before.

- Bond insurers have been drastically downgraded, resulting in a decline in value of insured bonds.
- The de-leveraging of the hedge fund industry has dumped huge supply into the municipal market.
- Yields on municipals are in some cases more attractive than Treasury yields, even on a pre-tax basis.

BENEFITS OF MUNI BOND FUNDS

These unusual conditions reinforce the reasons why actively managed municipal bond funds may provide sustainable advantages to your municipal portfolio.

- Stronger income strategy
- Flexible duration management
- Reduced transaction costs

A professional municipal bond fund manager may structure a portfolio that controls risk while trying to take advantage of opportunities in an inefficiently traded marketplace. If you are a taxable investor, this type of active management aims to deliver income, risk control and tax efficiency.

Actively managed funds also have the potential to offer additional returns to your portfolio, after adjusting for risk relative to market performance. For instance, larger municipal managers have negotiating power that may allow them to buy and sell bonds more quickly and potentially at more favorable prices. Municipal bond funds also can offer you ready access to your assets in the time frame and increments you need.

CONTINUED

ENHANCED INCOME STRATEGY

An actively managed bond fund can be adjusted frequently to reflect changes in interest rates and market conditions. The manager uses this flexibility to capitalize on yield and total return opportunities often not available to investors in static bond ladders. As interest rates and market conditions change, the fund manager can respond in ways that could protect your municipal bond investment's principal value and potentially enhance the income stream. For instance, actively managed bond fund strategies might:

- deploy deliberate duration strategies (barbell, bullet, etc.) in response to interest rate forecasts;
- over- or underweight certain bond categories and issuers based upon detailed credit analyses; or
- modify portfolio structure in anticipation of yield curve shifts.

Unlike individual bonds' stated semi-annual income payments, municipal bond funds provide a regular, monthly income distribution. And in contrast to a laddered structure, actively managed muni-bond funds adjust investments based on changes in the market and yield curve.

ADDING UP LADDER COSTS OVER TIME

A laddered municipal bond portfolio could incur transaction costs at any of the following stages:

- Initial investment
- Reinvestment at maturity
- Rebalancing/repositioning opportunities
- Unanticipated demands for cash

Over time, these costs could exceed those of an actively managed municipal bond fund and potentially reduce the ladder's total return.

An actively managed bond fund also typically comprises many individual bonds. This diversification, while no guarantee of a profit or protection against loss, potentially can reduce the impact that any specific troubled credits may have on your overall portfolio.

FLEXIBLE DURATION MANAGEMENT

By rigorously monitoring and managing a municipal bond fund's duration and maturity structure, the manager can position the portfolio to either increase income or protect principal in response to current or anticipated changes in interest rates. Duration provides one measure of a bond's sensitivity to interest-rate changes, or volatility.

An actively managed municipal bond approach seeks to offer more precise interest rate risk management than a laddered portfolio because the fund manager can quickly shorten or lengthen the fund's duration by shifting assets into more desirable maturities. The manager also can implement strategies that may capitalize on duration-related opportunities that aim to increase your total return without increasing interest rate risk.

LOWER FUND COSTS

Ultimately, the management fees for municipal bond funds can be less than the costs of building and managing a laddered municipal bond portfolio. Although this difference may be minor when a ladder's bonds initially are bought and if proceeds from subsequent maturities are reinvested, it can grow over time due to cash withdrawals and periodic portfolio rebalancings.

Depending on the account's size, these incremental transaction costs can potentially impair a bond ladder's total return performance. If your portfolio is $2 million or less, municipal bond funds may be especially cost-effective. Even in larger laddered accounts, holding a portion of the municipal assets in one or more funds may give you superior flexibility and cost-effectiveness.

EXPERIENCE, INSIGHT COUNT

During market uncertainty, actively managed municipal bond funds aim to capitalize on the municipal market's inefficiencies. They can potentially help maximize total return and income potential through yield curve strategies and lower transaction costs.

Find out how your municipal portfolio may benefit from Northern Trust's experience, market insight and focus on risk controls. Please consult your advisor about how an actively managed approach to municipal bonds may make even more sense now.

FOR MORE INFORMATION

To learn more, please contact your relationship manager or visit northerntrust.com to find an office location near you.

NORTHERN TRUST'S MUNICIPAL TEAM

Our team

- Management team averages 19 years of investment experience
- Expertise in macro strategy, research, economic research and trading
- Combination of experience and market insight
- Quality relationships with multiple dealers provide increased opportunities to access specific issues or trades

Our philosophy

- Active relative value
- Preservation of principal
- Total after-tax return
- Liquidity
- High credit quality

Our process

- Risk management
- Credit analysis
- Portfolio monitoring
- Credit research
- Economic research

CONTINUED

IRS CIRCULAR 230 NOTICE: To the extent that this communication or any attachment concerns tax matters, it is not intended to be used, and cannot be used by a taxpayer, for the purpose of avoiding any penalties that may be imposed by law. For more information about this notice, see http://www.northerntrust.com/circular230.

Northern Trust

Q24524 (2/09)