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Oppenheimer Rochester™ Muni Funds Are Something To Talk About

Managing Investment Risk in Municipal Bonds

Once upon a time, investors seemed largely focused on the reward side of the risk/reward trade-off. That fairy tale has now ended, having succumbed to the combined forces of extended volatility and a deeply felt recession.

The new narrative, unfortunately, has some investors focused almost exclusively on risk and, in fairy tale tradition, has pushed the plot to extreme conditions. It's no longer enough to have a thoughtful discussion with a client about the types of risks inherent in various types of investments. These days, an advisor must slay the fear-inducing giant that the media has made of risk and help investors see how risk/reward trade-offs have the potential to create advantages—even when investing in tax-free municipal securities or tax-free municipal bond funds.

> Today's advisors must slay the fear-inducing giant that the media has made of risk and help investors see how risk/reward trade-offs could be attractive.

The rules of suitability require advisors to understand their clients' tolerance for risk, among other things. The possibility that an equity's share price might zero out or that a bond might default must be disclosed before an investment can be made.

While these are real risks, we believe the probability that either will happen is far less likely than the probability that the equity's share price will merely rise or decline or that the bond will make its scheduled interest and principal payments on time and in full. Our industry's disclosure regulations are both comprehensive and cautionary, and they can help advisors understand their clients' true objectives and levels of risk tolerance.

Clients *do* need to consider the risk that an asset class or specific investment may not perform as expected. In the realm of municipal bonds, there's more to the story than investment risk. Nationally recognized statistical ratings organizations (NRSROs) assign ratings that they believe are aligned with the likelihood that a specific issuer will default on a particular bond. But as with any loan, even a highly rated one, there's a chance that the loan won't be repaid as promised. Bond insurance, once a mainstay in the muni sector, now seems like a distant memory, though many investors liked the idea that a second party would step in if the issuer's payments were interrupted. As investors learned during the subprime mortgage debacle of 2007-08, insurance is not the same as an ironclad guarantee.

Investors who are attracted to the notion of tax-free income but are still highly risk averse tend to favor high-grade muni securities, which have had extremely low default rates and, in our opinion, will continue in that vein. Additionally, these investors may veer toward shorter maturities, which historically experience less price volatility than securities with longer maturities. While this approach effectively reduces the level of risk, it also has some downsides: lower-yielding, high-grade securities generally deliver

less tax-free income than lower-grade bond investments, and this ultimately diminishes the investor's purchasing power.

We believe many investors stick with this approach because they don't appreciate that risk is not one of those four-letter words that sophisticated investors must avoid. Rather, we think advisors need to help their clients come to terms with the idea that all investments involve some degree of risk. In fact, smart portfolio managers spend considerable energy working to mitigate or offset risk.

Once educated, muni investors may be willing to assume certain kinds of risk that have demonstrated, over time, the potential to lead to higher levels of tax-free income. These include interest rate risk, credit (or default) risk and call/extension risk:

Interest rate risk: While some investors adhere to a "buy and hold" strategy with municipal bond investments, others focus on how the price of the bond may fluctuate over time as interest rates change. They are seeking reassurances that the market price will still be good—however they define "good"—should they decide to sell the bond before it matures or is called. In other words, they want to mitigate interest rate risk, the risk that the value of a bond will go down because of changes in market interest rates.

Oftentimes, investors seek out shorter maturity bonds as a means to avoid interest rate risk, knowing that they will be less sensitive to interest rate changes than longer-term bonds. Others invest in premium-coupon callable bonds, which will also be less sensitive to interest changes—as long as the coupon remains higher than market rates. Even so, investors may be subject to interest rate risk when a bond matures or is called if prevailing rates are lower than the bond's coupon.

One way to mitigate interest rate risk—and potentially enhance tax-free income generation—is to lengthen the average effective maturity of an investor's portfolio with the purchase of some bonds that mature at later dates. If the portfolio includes longer-term bonds, the investor will face less interest rate risk than if all bonds in the portfolio have relatively short maturities. A likely byproduct of this approach? Higher tax-free income distributions based on bonds that are closer to the long end of the muni credit spectrum.

Another way investors may be able to combat interest rate risk is by taking advantage of the extraordinary spreads that have existed recently between long-term AAA munis and long-term BBB munis. Lately, the yield spread has far exceeded the historical average of 111 basis points (or 1.11 percentage points). This means investors today are being paid more to assume the risks generally associated with lower-grade bonds.

Simultaneously, AAA munis have been "cheap to Treasuries," meaning that the nominal yields on the munis has been greater—on a pre-tax and after-tax basis—than the yields on U.S. Treasuries. This condition has lessened recently, but still represents—we believe—an attractive investing opportunity.

Credit (or default) risk: The risk that has garnered the most media attention of late and became the basis for many nervous investors' calls to their trusted advisors is credit (or default) risk. This risk focuses on the possibility that the borrower will not be creditworthy, will run into financial difficulties or will, for some other reason, fail to honor its schedule for debt service payments.

The fear that we could see "hundreds of billions of dollars" in defaults has resonated with many retail investors, despite the growing chorus of muni experts who have challenged this assertion, which was made by banking analyst Meredith Whitney on a "60 Minutes" episode. Her prediction was widely disseminated by others in the media, many of whom did not adequately question Ms. Whitney's perspective.

The State of the States

The budget-balancing woes of state and local governments have been a source of anxiety for many taxpayers. Many investors in the municipal bond market, we believe, have assumed that the budgeting and pension funding headaches within their states will adversely affect them, too. We think bondholders need not be overly concerned about either topic.

Even the most contentious state budgets, we note, eventually get balanced, as is required by law in 49 states. Because states need ongoing access to municipal financing, they are highly motivated to avoid any changes to their debt service payments when looking for budget lines to reduce or eliminate. Additionally, interest payments on general obligation debt typically constitute a relatively small portion of state and local government spending; a 2011 article by state tax and budget experts at the Center on Budget and Policy Priorities put the figure at "a modest 4 or 5 percent." We believe it would be highly unlikely for state or local officials to risk jeopardizing their municipality's creditworthiness over such a relatively small proportion of spending

The question about whether states have adequately funded the pension plans for their employees has been fiercely debated

As a result, we believe, not as many investors paid attention when muni experts cited the well-respected, longitudinal study of municipal and corporate defaults among bonds rated by Moody's Investors Service. In the Moody's study of bonds it has rated between 1970 and 2009, the average cumulative default rate for the *lowest* investment-grade muni is 0.16% within 10 years (that's less than one-sixth of 1 percent); among Moody's higher-rated, investment-grade munis, the comparable figure was 0.03%—at worst!

By comparison, the average cumulative default rate among Moody's highest investment-grade corporate bonds was 0.50% within 10 years.

A bond's initial rating will, of course, deteriorate over time if the issuer's ability to honor its debt service agreement changes or seems likely to change. Thus, bonds that get downgraded are considered more likely to default than when they had higher NRSRO rankings. More than 70% of the corporate bonds in Moody's lowest-rated credit category, according to its study, defaulted within 10 years. The comparable figure for Moody's lowest-rated munis was less than 12%, a rate that is understandably off-putting to some investors but also largely avoidable.

Without these facts, many investors (and reporters) have developed a highly exaggerated sense of how great the risks are in the muni sector. Most if not all investors, we would assert, have heard Ms. Whitney's claims about the future muni landscape. Few, we imagine, have read this compelling quote from a March 2011 *Bond Buyer* article: "Corporate defaults in 2009 alone were more than five times the number of municipal defaults over the past 40 years."

Advisors have the opportunity—and responsibility, we believe—to ensure that their clients' perspectives reflect more than what the mainstream media serve up.

Investors with more sophisticated perspectives on real risk levels in the muni sector have adopted a number of strategies in their pursuit of higher levels of tax-free income. Some have seen fit to invest—judiciously—in BBB-rated bonds (the lowest investment-grade classification), in below-investment-grade bonds and/or non-rated (or "unrated") bonds. This latter type of bond—by definition, securities not rated by an NRSRO—may or may not be equivalent to investment-grade securities. Investors often err in thinking that unrated bonds must be below-investment grade. Issuers may have similar investment-grade paper and simply want to skip the expense of seeking an NRSRO rating. Other issuers may want an earlier date of issuance than would be possible if they waited for an NRSRO rating and are willing to offer the bond without a rating but with a slightly higher coupon.

In our experience, three other factors may help investors take advantage of credit risk/default risk: building diversification into their portfolios, maintaining a long time horizon and conducting (or having an expert conduct) in-depth and security-specific credit research.

Call and extension risk: These two types of risks represent opposite sides of the same coin. If a bond gets called at par before its final maturity, an investor is dealing with call risk. This occurs, typically, when an issuer sees lower yields in the marketplace and determines that it will be less expensive to pay back higher-coupon securities early and secure new financing for its projects. The investor who had assumed that the bond would pay its coupon until maturity will receive less tax-free income than had been originally expected, and may have less attractive opportunities to reinvest the proceeds in the current marketplace.

The opposite kind of risk is extension risk, which occurs when interest rates rise and the issuer sees that a par call will require future financing to be negotiated at higher rates. The investor, who was once content with the coupon offered by the purchased securities, now may face some buyer's remorse. This investor would be happier if the issuer called

of late. We believe this is a much longer-term problem than current debates have suggested and that most states and localities have the ability to improve pension finances, especially when tax revenues are rising.

In early 2011, Wilshire Associates reported a 4 percentage point improvement in the overall funding levels of state pension funds, for the year ended June 30, 2010; at 69%, the overall funding level is just shy of the level Fitch Ratings considers adequate and has clearly moved in the right direction. The Center for Retirement Research at Boston College, meanwhile, asserts that most plans have sufficient assets for at least 15 years, under the most stringent conditions. The Center also calculated how long pension assets would last under a "more likely scenario." Most Americans, we believe, would not have guessed that "30 years" would be the right answer.

Thanks to 24/7 media and online coverage, investors now have access to more market news than at any time in the past. While this may make some investors better informed, it may also drive investors to errant conclusions. As always, we encourage advisors to help their clients separate the wheat from the chaff.

the bond and the investor could then reinvest in securities offering higher coupons.

Some advisors advocate the use of bond ladders, consisting of bonds that mature in staggered fashion over time, as a means to limit an individual investor's extension risk. With a ladder, cash frees up on a semi-regular basis, as each rung of bonds matures, and can be reinvested in the muni market at prevailing rates. If today's market yields are not fully satisfying, the investor at least knows that another opportunity to invest in munis will present itself when the next rung of bonds comes due.

Fund managers seeking to mitigate call and extension risk can add premium-coupon callable bonds to their portfolio's mix. Typically, we have found, these bonds are strong credits that have been priced to a near-term maturity, which limits price volatility. We like that they generate above-market yields, often for long periods after their call dates. Even if market rates have declined, an estimated 60% of premium-coupon callable bonds never get called. The muni investor, in these cases, benefits from inefficiency of this enormous over-the-counter market. The investor will thus continue to pocket higher levels of tax-free income than could be acquired in the current marketplace, all the while hoping that the issuer will continue to forgo refinancing, which can be cumbersome and costly.

Solving a client's income needs, we believe, requires thoughtful asset allocation and diversification of holdings. Often it requires expanding a client's comfort zone. Some clients can afford to remain content with short-term, AA bonds, even at today's low yields. If your clients are happy with this arrangement, great. For other clients, even small allocations into longer-term and/or lower-rated municipal holdings have the potential to produce an increase in tax-free income.

Advisors clearly need to continue to keep their clients' objectives in mind, but they also have the chance in today's economy to broaden their clients' perspectives about risk. Yes, risk is a four-letter word, but that doesn't mean it cannot be spoken in polite society. The best advisors, we believe, will show their clients how risks can be managed and how portfolios that assume even a small amount of incremental risk can outperform "risk-free" portfolios. It's a conversation worth having—especially if your clients have an appetite for the higher levels of tax-free income that more diversified bond portfolios may be able to provide.

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