



BUILD AMERICA BONDS

SUMMARY OF KEY FACTORS OF BABS

- Allow taxable buyers to diversify their portfolios
- Reduce tax-exempt financings, which could improve the overall value of tax-exempt holdings
- 2010 expiration date may be extended or even made permanent
- Issuers of BABs still retain the option of issuing bonds on a tax-exempt basis
- No federal guaranty—creditworthiness solely that of the issuer

INTRODUCTION

Build America Bonds (BABs) are a new and attractive alternative for taxable investors. Widely accepted in the marketplace, these bonds were created as a result of the federal stimulus legislation passed in early 2009 by the Obama Administration. A new type of debt instrument, BABs offer municipalities a 35% federal subsidy on interest payments when they borrow money by issuing taxable bonds.

WHAT ARE BUILD AMERICA BONDS?

The \$787 billion American Recovery and Reinvestment Act of 2009 (ARRA) included provisions that have dramatically broadened investor demand in the municipal bond market. Public issuers now have the option of replacing traditional tax-exempt financings with taxable bonds, most of which are known as Build America Bonds.

One provision of the 2009 ARRA stimulus package is the Direct Pay BAB, which is a taxable municipal bond whose proceeds are required to be used for qualified capital expenditures designed to stimulate the economy. Such expenditures include, but are not limited to, school projects, transportation infrastructure, water and sewer systems, tunnels and other essential public facilities. Issuers of taxable BABs receive a 35% rebate of interest paid from the federal government. As an example, if the interest cost to an issuer of a BAB is 5%, the issuer is effectively paying 3.25% after the 35% federal credit is factored into the equation. The government subsidy is *not* a guarantee and does *not* enhance an issuer's creditworthiness. Regardless, the federal subsidy makes BABs a relatively cost-effective way for state and local governmental entities to borrow money.

WHO SHOULD BUY BUILD AMERICA BONDS?

Taxable municipal bonds have been around for some time in various forms due to the IRS regulations which limit use of tax-free financing in certain situations (i.e. the funding of municipal pension liabilities). The 2009 arrival of BABs has raised the profile of taxable municipal issues in general, and will continue to do so through 2010, when the ability of issuers to originate BABs will sunset under provisions of the stimulus legislation.

From an investor's standpoint, the interest income from BABs is federally taxable, so the structure cannot fully replace the tax-exempt income sought by traditional municipal bond buyers. Nevertheless, taxable BABs have gained wide acceptance, particularly from investors who don't need the benefit of tax-free income. These investors include traditional retail investors, insurers, pension funds, corporations, trusts and even foreign investors. The effects of this acceptance have significantly reduced the amount of tax-free municipal bond issuance which has, in turn, reduced the amount of tax-free investment opportunities in the marketplace.

Many investors with tax-advantaged accounts—IRAs for example—seek the higher pre-tax yields which are offered by taxable bonds and have traditionally bought corporate bonds, mortgage-backed securities and other taxable issues. For these investors, BABs offer a new and attractive alternative as well as the opportunity to achieve broader diversification within their portfolios. From a credit perspective, BABs offer a lower risk profile than traditional taxable investments. Based on the methodology used by the ratings agencies, an A-rated municipal issuer is likely a stronger credit than an A-rated corporate issuer. In fact, the default rate for A-rated municipal bonds has been 0.25% over the last 23 years according to Standard and Poor's data. This compares very favorably to the 2.91% default rate experienced by A-rated corporate issues over the last 15 years.

Since BABs compete more often against corporate bonds and other taxable debt, early issuers of BABs have accommodated the structural preferences of taxable investors which include:

- Maturities in the 20 and 30 year range (although there are exceptions)
- Redemption provisions that tend to be more favorable to investors including non-callable or make whole call features (although some new issue BABs have been structured with traditional 10-year call options)
- Bonds are usually issued as “bullets” meaning there are no sinking fund features

As investors become more comfortable with the BAB product, future issuance will begin to mirror more traditional tax-exempt structures including shorter maturities and traditional redemption provisions.

CONCLUSION

The introduction of BABs is the biggest thing to happen in the municipal marketplace in many years and has resulted in a broad acceptance by both institutional and retail investors. BABs have given issuers new financing options, opening the municipal market to taxable investors who rarely (if ever) participated in the past. BABs also give taxable investors the opportunity to diversify their portfolios with these new taxable municipal investments. This makes the BAB a worthy consideration as a standalone allocation in any tax-advantaged portfolio.

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