



Higher Income Taxes and Financial Market Uncertainty Enhance a Compelling Case for Municipal Bonds

Though they went to overtime, Washington's "fiscal cliff" negotiations eventually ended in an agreement that will mean higher taxes for millions of Americans beginning in 2013. In addition, with a stop-and-go economic recovery, an ongoing European financial crisis, and a U.S. federal debt burden that now exceeds \$16 trillion, it's easy to see why so many of today's investors are inclined to adopt a defensive stance. Traditionally, defensive strategies centered on tilting portfolios toward cash and bonds. Today, things are more complicated. Federal Reserve intervention has turned inflation-adjusted money market yields negative. Meanwhile, for those eyeing the bond market, generationally-low interest rates and the prospect of inflation present an intimidating risk-reward proposition.

Fortunately, the fixed income universe encompasses many segments. We feel that, among those segments, municipal bonds present reasonable valuations, substantial after-tax yields and a risk/reward proposition that distinguishes them from both Treasury and corporate bonds.

Municipal Bonds: When Bad News is Good News

To grasp the benefit of allocating assets to municipal bonds, investors must first see through recent dramatic headlines about state and local governments' budget pressures and realize many of those headlines are actually a positive where investors are concerned. While curtailed services, slashed payrolls and other austerity moves aren't welcome developments among those living in the affected communities, they *are* good news for municipal bond investors—since they reflect issuers taking necessary steps to balance budgets and protect debt obligations.

Of course, while austerity moves are one thing, bankruptcies are another matter. In 2012, we witnessed the attention-grabbing bankruptcies of three California cities: Stockton, San Bernardino and Mammoth Falls. To put these three bankruptcies in proper perspective, however, it's important to recognize that the municipal bond market comprises more than 50,000 issuers and that—as the nearby chart indicates, the default rate on municipal bonds has historically been a mere fraction of the rate observed on corporate bonds.

The municipal bond market owes its low default rate to three important characteristics:

- **Municipalities have fiscal constraints.** For example, unlike the federal government, 49 of the 50 states have constitutional or other requirements to balance their budgets. Similar restraints are common among local entities.
- **Municipalities are highly motivated to avoid default.** With no alternate source of capital, state and local governments can't afford to burn the bridges that connect them to the credit markets.

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- Municipal bonds can present a compelling risk/reward proposition.
- Higher taxes can make the tax-free income more valuable.
- State and local austerity measures appear to be good news for muni investors.
- Muni bond supply-and-demand dynamics currently are favorable.
- Investors must weigh four factors when choosing municipal bond funds.

Municipal Defaults are a Rarity Ten-Year Cumulative Default Rate

(All Rated Bonds, as of 12-31-2011)



Municipal bonds are exempt from federal taxes and from most state and local taxes. Corporate bonds are backed by the payment ability of the issuing company. Corporate bonds are generally considered higher risk than government bonds.

Past performance is no guarantee of future results.

- **Municipalities have a wide array of budget-balancing tools at their disposal.** From increasing taxes and fees to trimming payrolls, reducing services and renegotiating pension agreements, most muni issuers maintain adequate flexibility to move on both sides of their cash flow.

In addition to those dynamics, most muni bonds are either backed by a dedicated revenue stream, or a pledge to raise taxes as necessary to meet interest and principal obligations. Taken together, it's no surprise that, out of the vast municipal universe, Moody's observed a mere 71 rated defaults between 1970 and 2011. Even those bond default stories ended relatively well, with a median 80% recovery rate.

That said, those California bankruptcies do offer an important take away: While municipal credit analysis has traditionally focused on an issuer's **ability** to pay, these moves highlight an increasing need for credit analysts to focus on an issuer's **willingness** to pay. It's also important that investors are able to understand the security features of the bonds they're buying.

Favorable Supply and Demand... and More Taxation

Just as austerity headlines might lead investors to draw the wrong conclusion about the health of the nation's municipal bond issuers, a casual observer may likewise draw a wrong conclusion from bond issuance data.

Issuance was up in 2012; this doesn't, however, indicate a glut of new supply. Rather, much of that issuance represents refinancing by municipalities taking advantage of lower rates to reduce their debt-service costs.

The supply-demand equation has some other important dynamics working in its favor. As issuers pursue refinancing strategies, bonds are being called out of municipal portfolios, compelling managers to reinvest the proceeds. Through the course of 2012, Lipper reported U.S. municipal bond funds have experienced net cash inflows in all but two weeks of 2012.

The increase in marginal tax rates for individuals and the exclusion of municipal bond interest from the new 3.8% surtax on investment income makes municipals more attractive. Uncertainty about future federal income tax policy always presents a wild card for municipals. That remains true today, as the country awaits Washington's next move in the face of the federal budget deficit and looming debt-ceiling debate.

Municipals Stack Up Well Against Treasuries and Corporates

Treasury securities have long been thought of as a source of "risk-free return."

In the wake of prolonged Federal Reserve intervention that has distorted market price signals and pushed yields ever closer to zero, one might

now say that Treasuries instead present a "return-free risk." With rates so low, a turn in interest rates—whether initiated by the Fed or demanded by investors—could translate into significant capital losses for Treasury investors.

Systemic shifts in interest rates are beyond an investor's control. While municipal bonds offer no immunity to a broad rise in interest rates, their higher coupons could help buffer them from the degree of impact that would be seen in the Treasury market. Despite the recent rally, municipal bonds still offer yields that are relatively attractive, especially on an after-tax basis (as seen in nearby chart).

That interest rate advantage is also evident when comparing municipal bonds to corporates. There are two more attributes that provide a sharp contrast between corporates and municipals: Municipalities don't go out of business and, since they can't tap the equity markets, they're tightly focused on meeting credit obligations to preserve access to the bond market.

It's also important to note that municipal credit quality is stronger than corporate credit quality—for example, the 10-year cumulative default rate for rated municipal bonds is 0.13%, a tiny fraction of the 11.17% rate observed on rated corporates.

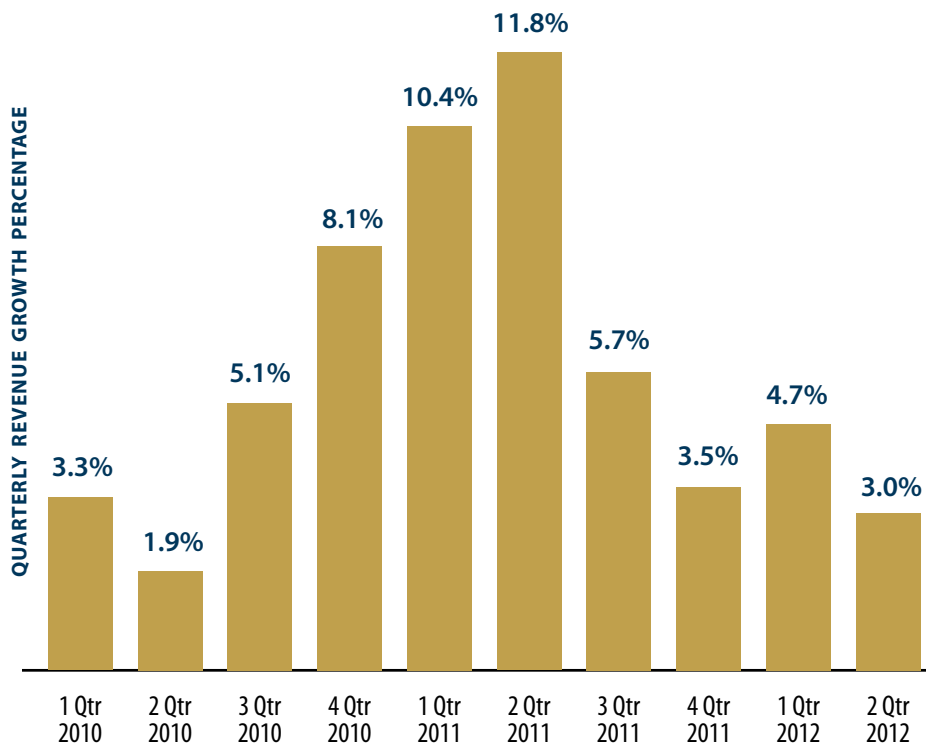
Finding Value Within the Municipal Market

Just five years ago, the municipal market was dominated by AAA-rated insured bonds, making the market far more homogenous and seemingly commoditized. With municipal bond insurance largely vanishing from the investment landscape, fundamental credit analysis and security selection are where mutual fund portfolio managers have the greatest opportunity to add value.

Depending on one's time horizon and risk tolerance, we believe investors should take a diversified approach to owning municipal

States Post Steady Revenue Gains

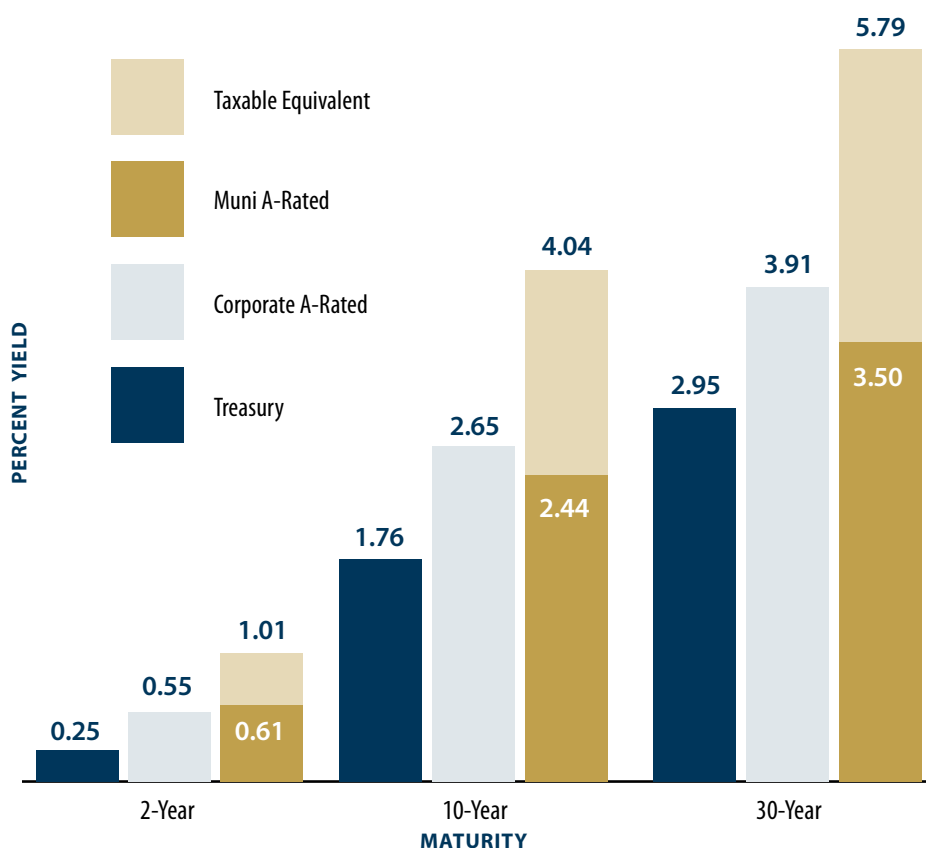
Quarterly State Revenue Growth



Municipal Yields Are Very Competitive

Yields as of 12.31.12

Taxable-Equivalent Yield Assumes 39.6% Tax Rate



bonds across the maturity spectrum. Those investing in municipal bonds via mutual funds should consider several key factors when narrowing their choices:

- Tax efficiency and the components of portfolio return.** Today, it is easy to realize capital gains in municipal securities—something that hasn't been particularly difficult in a falling-rate environment. If the proceeds of a sale are reinvested at a lower coupon, this will lower portfolio income and increase volatility. It also harms tax efficiency, since the municipal bond tax exemption doesn't apply to capital gains. Also, many funds invest in bonds subject to the alternative minimum tax.
- Tax-exempt income.** In contemplating the possibility of rising interest rates, it's important to remember that—all things equal—a portfolio with higher coupon bonds offers better defensive characteristics, since it will have more income to offset capital losses. Bond funds are fixed-income investments, and over the long run, interest and compounded interest comprises the bulk of total return. That said, yield shouldn't be the only consideration: Simply "reaching for yield" could lead investors to funds that may be taking unwarranted risks.
- Long-term performance.** Rather than focusing on the most recent year or quarter, investors should observe a fund's 3-, 5- and 10-year performance, with an eye on how it fared in both falling and rising interest rate environments.
- Portfolio holdings.** Investors should be aware of what is in the portfolio. For example, look for bonds subject to alternative minimum tax, taxable bonds, leveraged positions and investments in nonrated securities. Be aware of the risks in the portfolio; not all risks are bad, but investors should understand which ones they're taking and determine if they're being compensated appropriately.

Past performance is no guarantee of future results.

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