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Lumen – the Latin word for light

Registered Investment Advisor

Building Your Portfolio with Build America Bonds

Lately, Build America Bonds ([BAB](#)) are like Rodney Dangerfield. They just get no respect. While stocks and commodities have soared since the end of August, BABs have stumbled.

To start, BABs are taxable municipal bonds on which the federal government subsidizes the state and local issuers by paying 35% of the interests. In exchange for the federal subsidy, interest income from BABs is subject to federal income tax. The BAB program was started in 2009 by the federal government to help local governments finance new projects by lowering their borrowing costs. The program expires at the end of 2010.

To be sure, BABs' recent trouble is not unique in the bond market. After a three-decade secular bull market that saw 30-year Treasury rate fall from over 13% in 1981 to 4% this past October, bond's ascent is coming to an end. Bond yields really cannot get much lower. This means yields are likely headed higher rather than lower, and it means falling bond prices.

But the general bearishness in the bond market is only the beginning of BAB's problems. As investors began to compare municipal debt to Greek sovereign debt, all municipal bonds, including BABs, are taking a hit. Never mind that not all states are like Greece. After experiencing so much anxiety in the past two years, investors are ready to head for the exit at any sign of trouble. More than ever before, the market modus operandi is, 'sell first, ask later'.

As if a double-whammy is not enough, BABs have a third and unique problem. As mentioned earlier, the BAB program is set to expire at the end of this year unless it is extended. Without federal subsidy provided by the BAB program, states and local governments will see their borrowing costs rise next year. Therefore, municipalities are rushing to issue BABs before the yearend deadline. The sudden supply surge flooded the market and drove yield down. Then when it was announced that the latest tax proposals from the White house did not include an extension of the BAB program, BAB plunged and average yield climbed to 6.35%, an 11-month high, on December 8. BABs, it appears, are in a perfect storm.

But perfect anything is only in the eyes of the beholders. A perfect storm for some can be a perfect opportunity for investors. At current yield, many highly rated BABs are yielding higher than lower rated corporate bonds. For example, the PowerShares Build America Bond ETF ([BAB](#)), with an average rating between AA

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and single-A and an average maturity of about 23 years, has an SEC 30-day yield of 5.82%. This compares favorably to the 5.62% for the iShares 10+ Year Credit Bond ETF ([CLY](#)), which has similar ratings and maturity. Given that the historical default rate of municipal bonds is much lower than that of equally rated corporate bonds, and given the taxing power of local governments, municipal bond should yield less than their corporate counterparts. Furthermore, with the additional 35% federal backing, BAB should yield even lower than standard munis. But as it is, BABs now yield higher than corporate bonds.

In addition, if local governments are rushing to beat the BAB program deadline by borrowing more funds now, their need to borrow will be less later. This makes new muni issuance scarcer after the BAB program expiration and should make munis more valuable. More importantly, there will be no more new BABs after the deadline, therefore making existing BABs even more valuable, especially with their attractive yield.

Surely, just because BABs in general appear attractive does not mean all BABs are good. Munis, including BABs, are cheap for a reason. They are cheap because the stress on the finances of states and other local governments is very real. This is why investors should avoid buying a generic basket of BABs via an index fund or an index ETF. Investors need to sort through the pickings carefully to find the gems, and who better to find hidden gems in the bond market than Pimco and Blackrock? These two top bond houses have the experience to navigate the bond market and separate the good credits from the bad.

So let's start with Pimco. In this past September, the firm introduced an actively managed BAB ETF, the Pimco Build America Bond Strategy Fund ([BABZ](#)). The ETF has an expense ratio of 0.55% and is trading at a small premium of 0.06% to its net asset value. It has an SEC 30-day yield of 5.27%.

A more aggressive and higher yield alternative to Pimco's ETF is Blackrock's BAB closed-end fund, Blackrock Build America Bond Trust ([BBN](#)). Like Pimco's fund, BBN is actively managed in order to weed out the bad credits. And like many other closed-end funds, BBN intends to use leverage to boost yield. In its prospectus, BBN projects an annual expense ratio between 0.62 (without leverage) and 1.59% (with leverage). It is currently trading at a 0.62% discount from net asset value and yields just north of 8%.

Finally, as George Soros said recently, 'nothing is very safe' these days. We are in a brave new world in which volatility will be higher than in the good old days;

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and government securities such as Treasuries and municipal bonds are no longer the sleepy safe haven that they once were. But if one has to buy some bonds, short of going to emerging markets, BABs offer some of the best risk-adjusted reward, for BABs are the most mispriced among the various fixed income segments and investors are compensated with a reasonable yield while waiting for the market to reprice them higher.

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