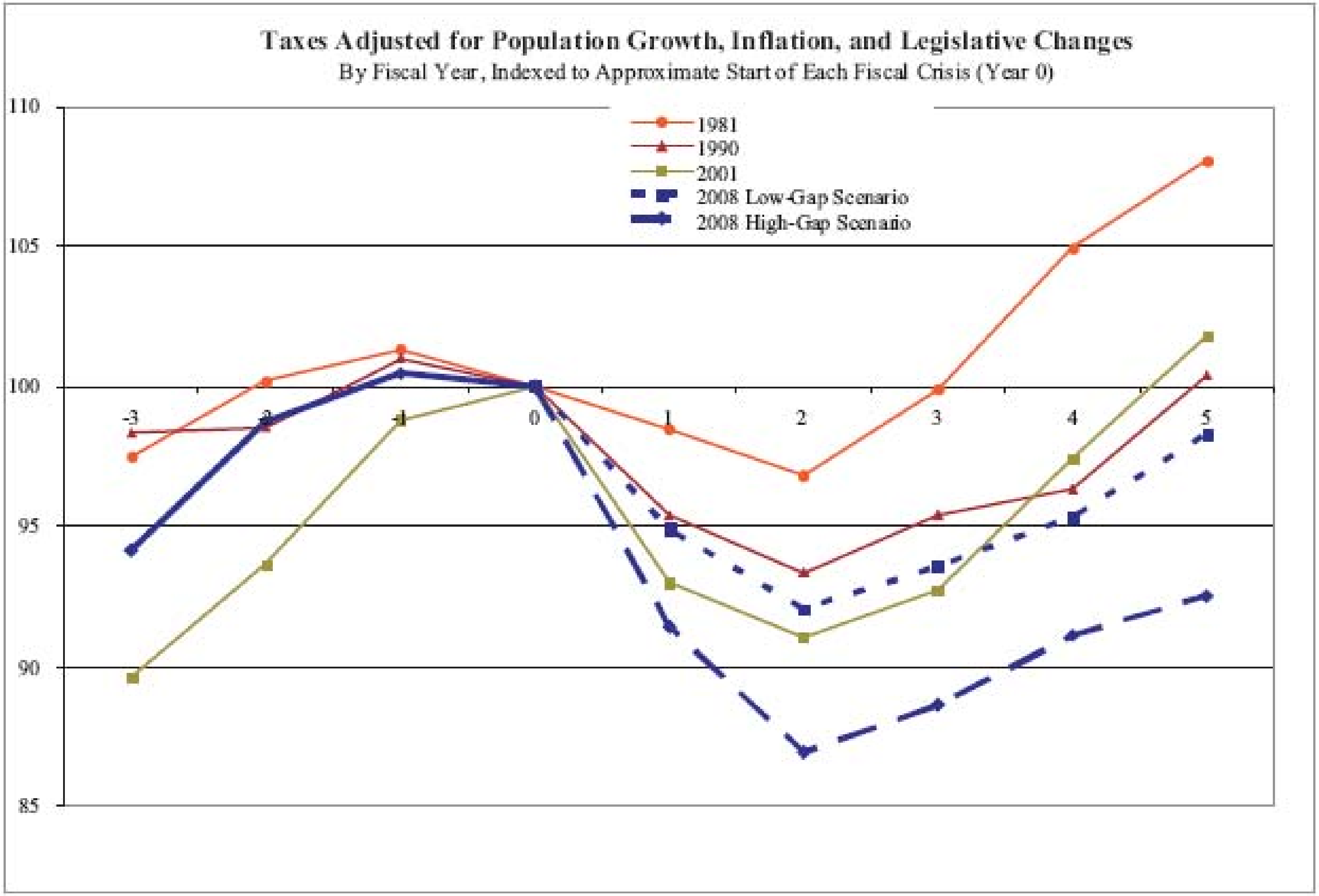
California Debt and Investment Advisory Commission / Bond Buyer Public Finance Conference

Nuveen Asset Management

September 14, 2009

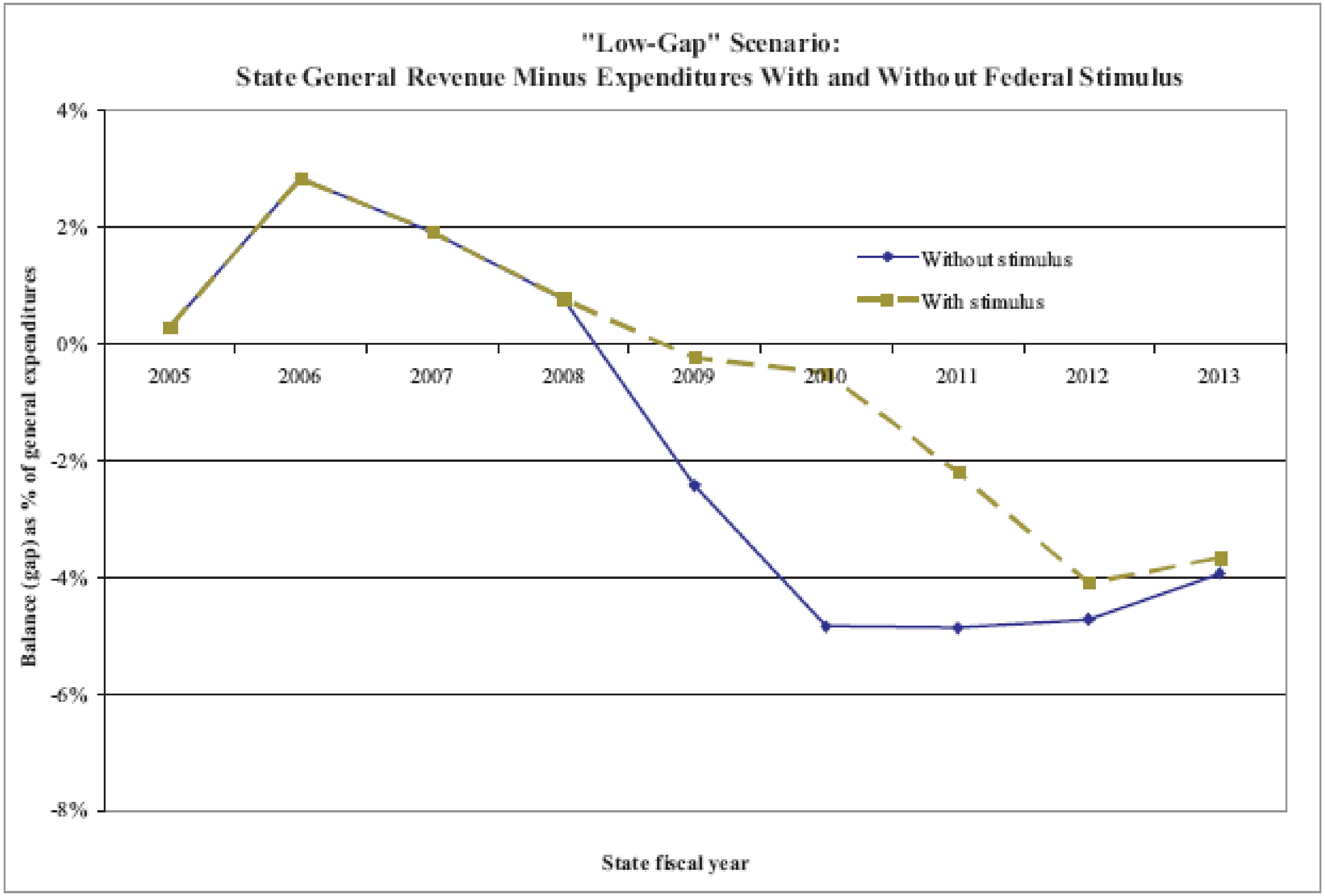
Cadmus Hicks

A long time to recover



Source: Donald Boyd, The Nelson A. Rockefeller Institute of Government

After the Stimulus



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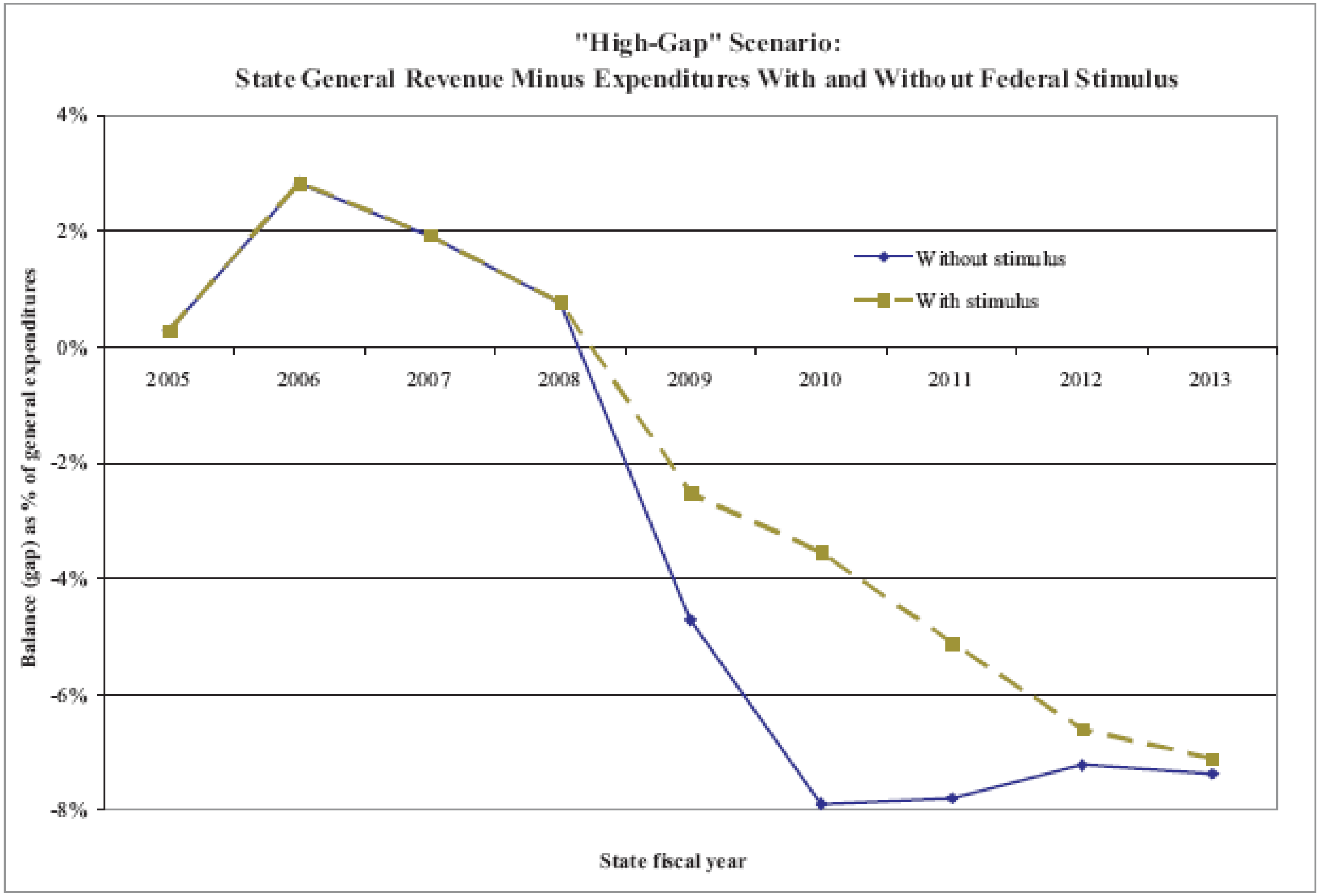
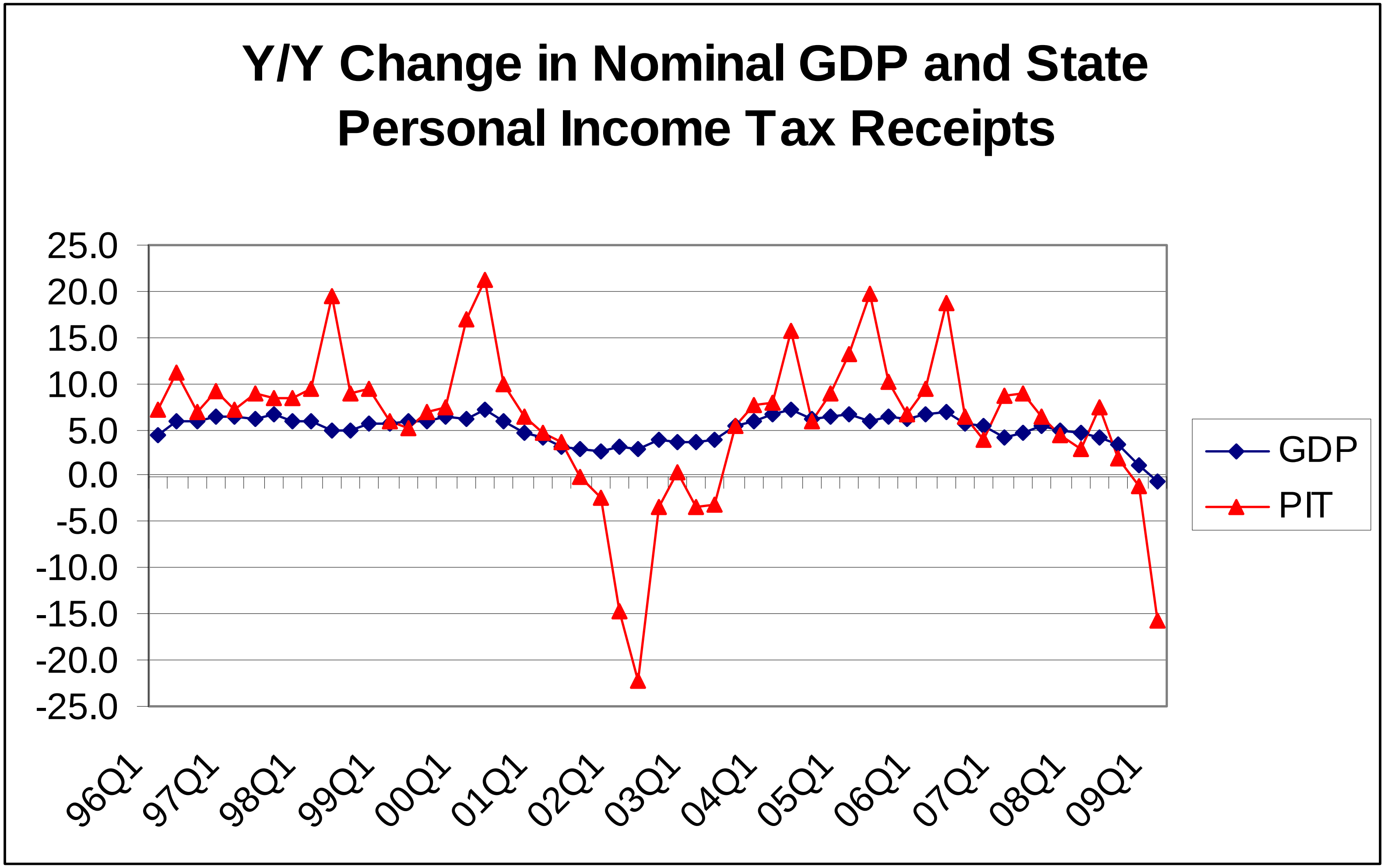
After the Stimulus

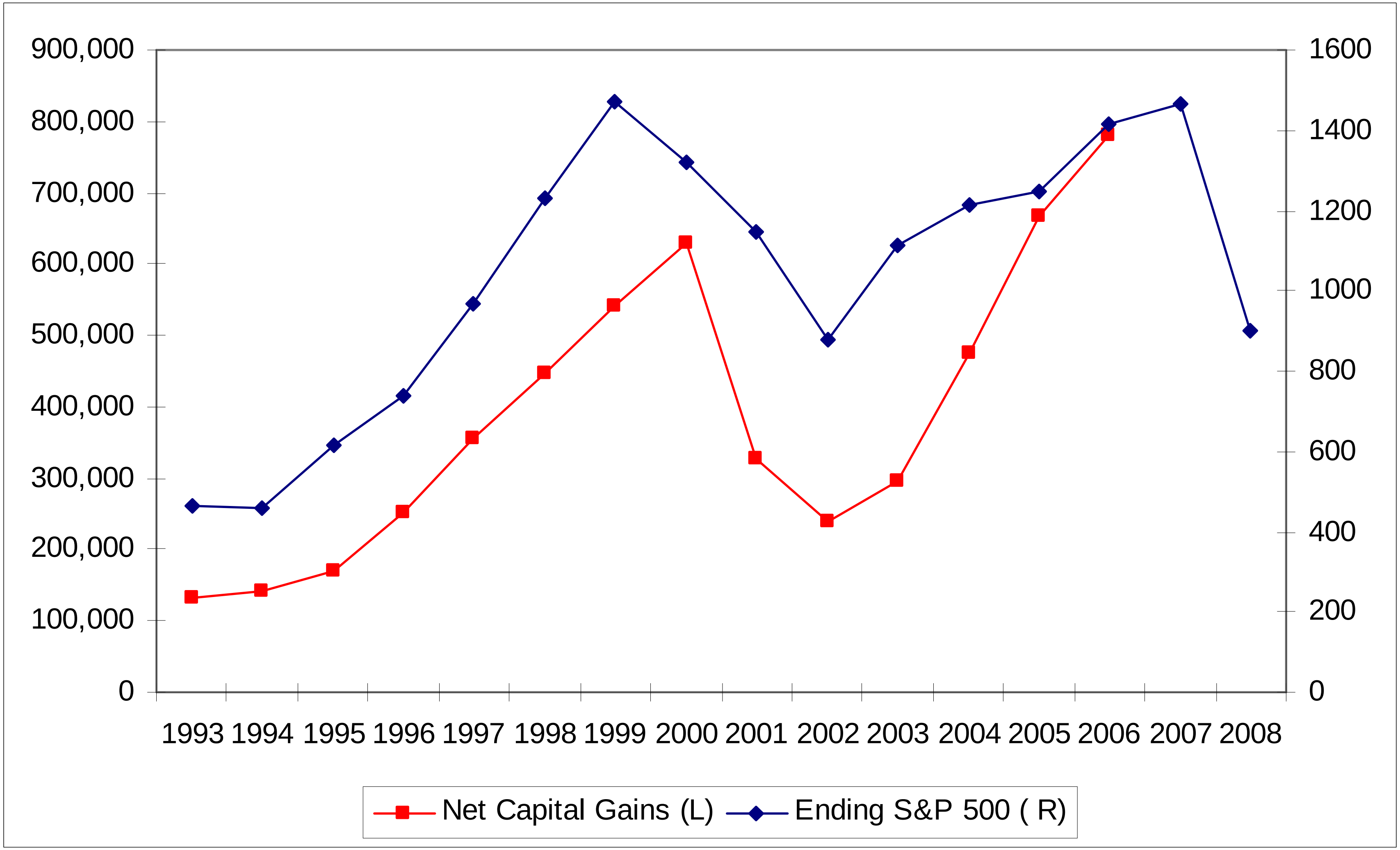


Source: Donald Boyd, The Nelson A. Rockefeller Institute of Government

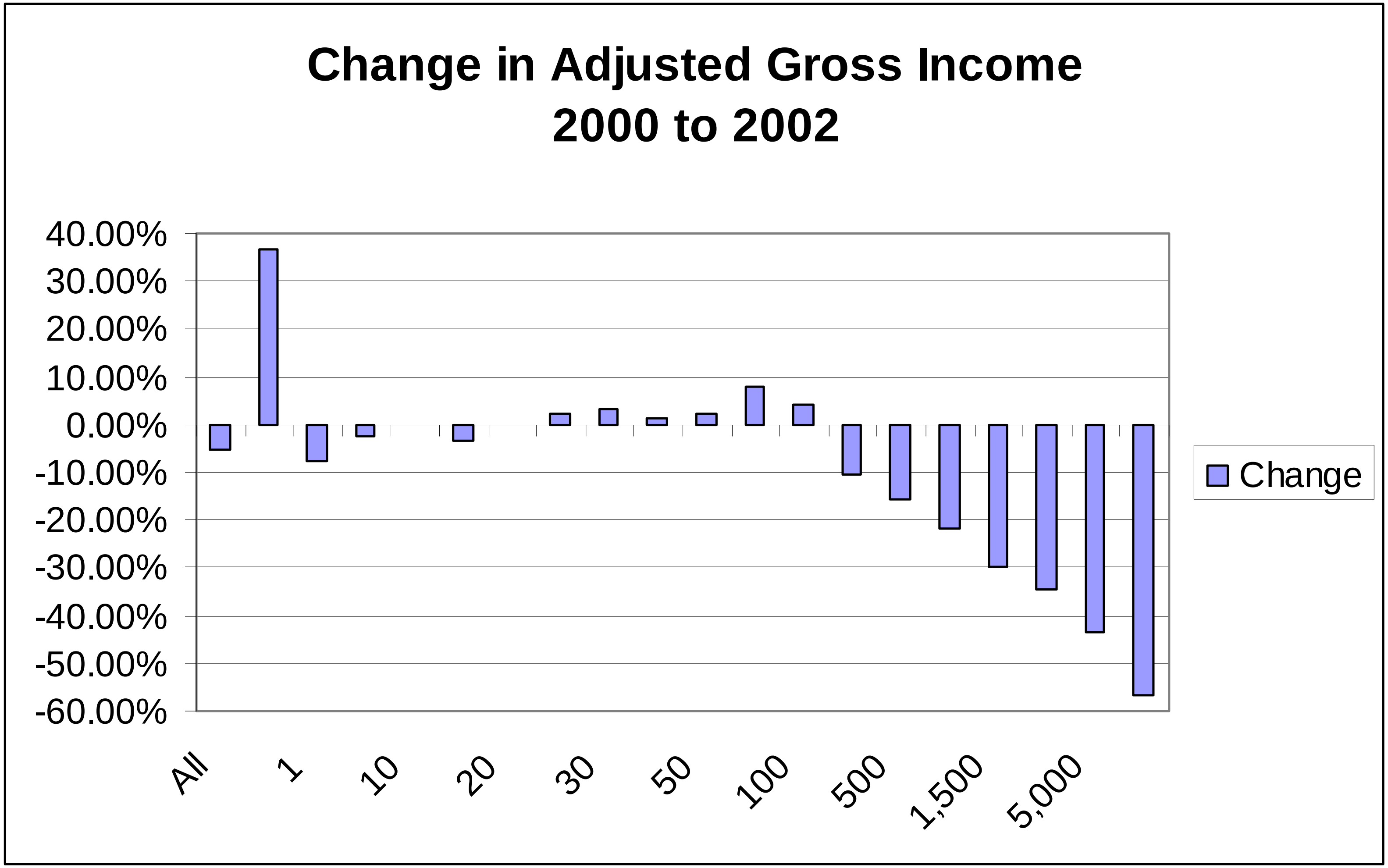
State Income Taxes, More Volatile than GDP



Capital Gains and S&P 500



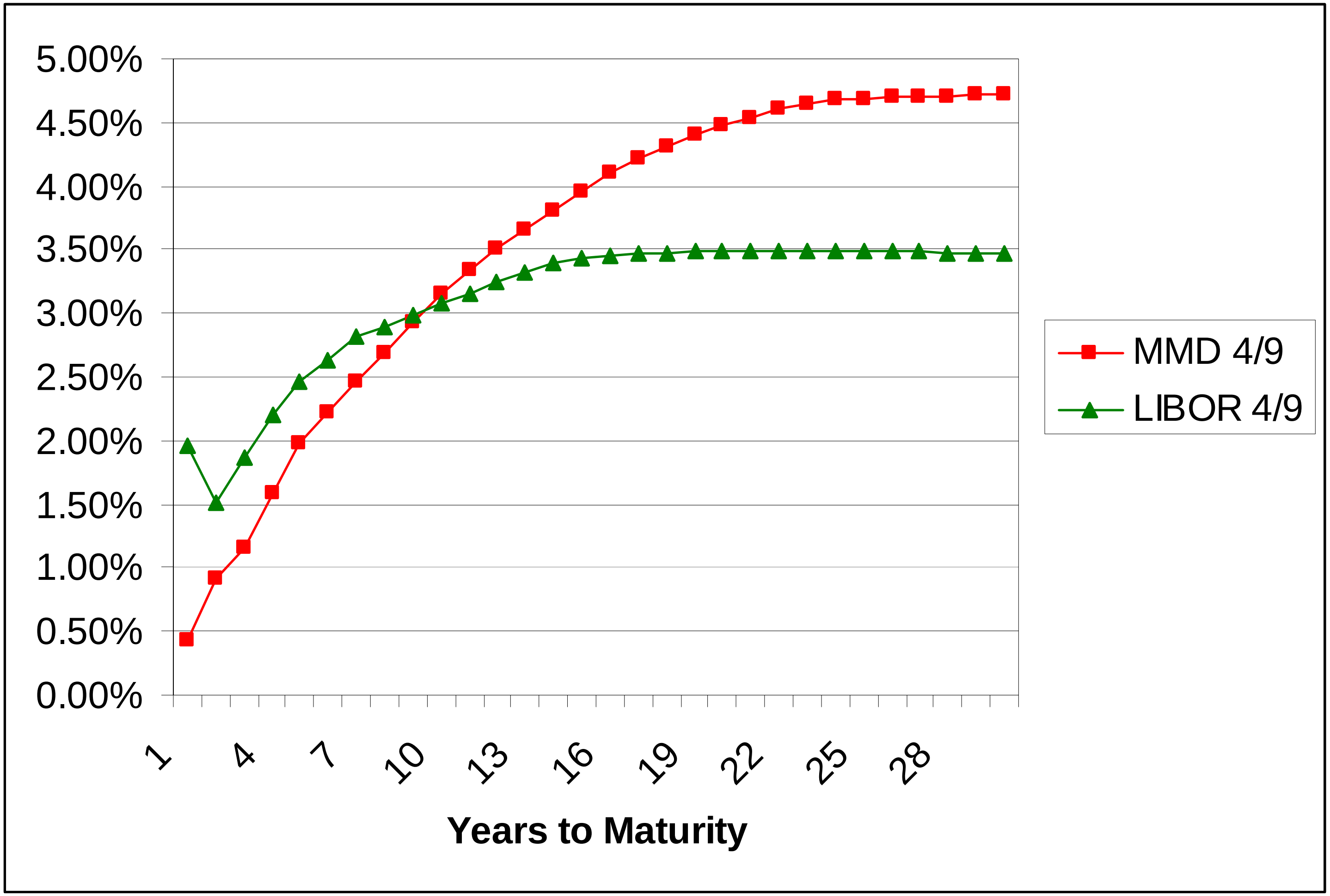
Progressive tax rates add to volatility



Build America Bonds

- Over $28 billion issued through the end of August.
- $21.7 billion matures in more than 20 years.
- Reduction in tax-exempt supply has helped:
    - Lower tax-exempt yields.
    - Lower the ratio of tax-exempt to taxable yields.

Tax-Exempt and Taxable Yields



Tax-Exempt and Taxable Yields

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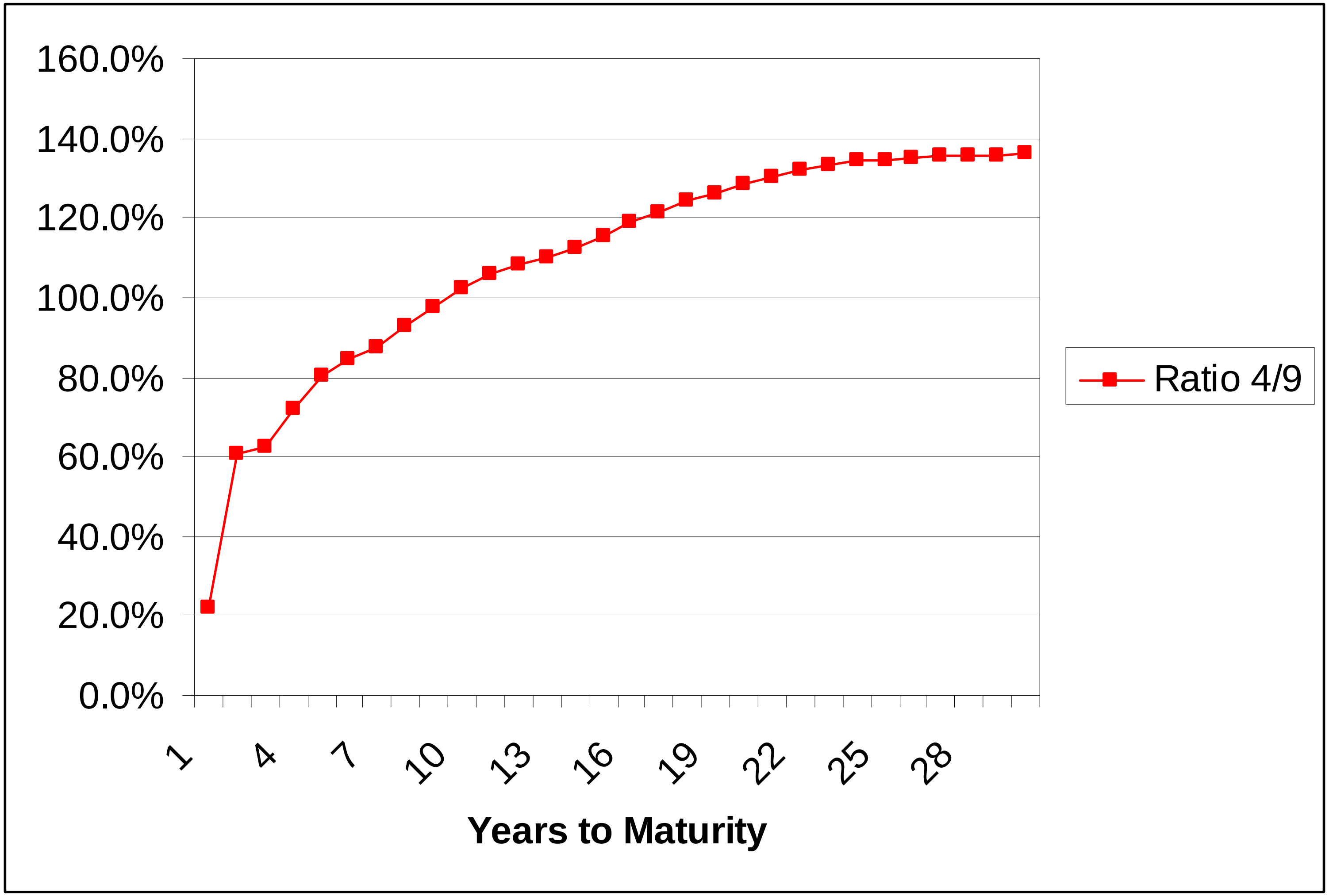

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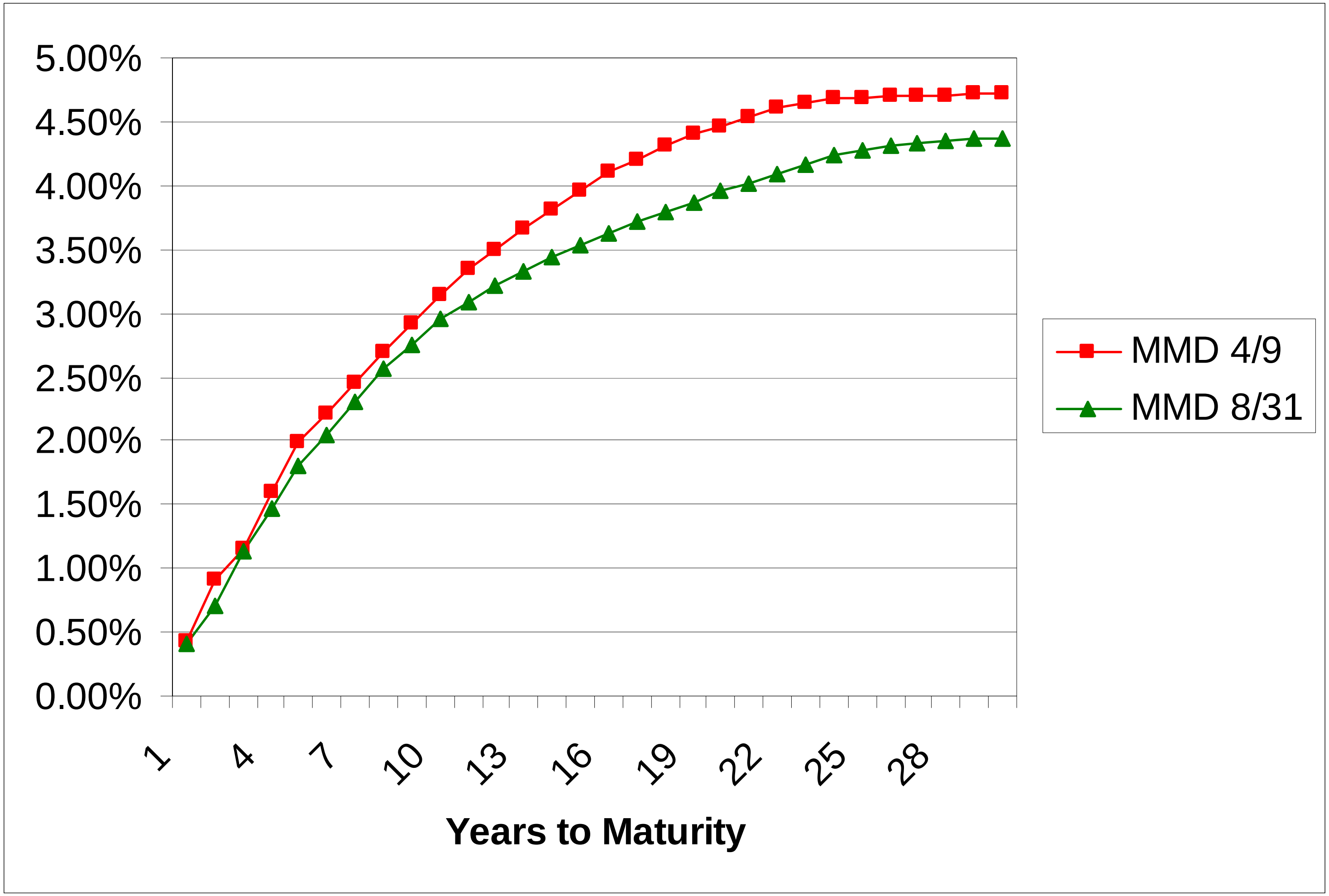
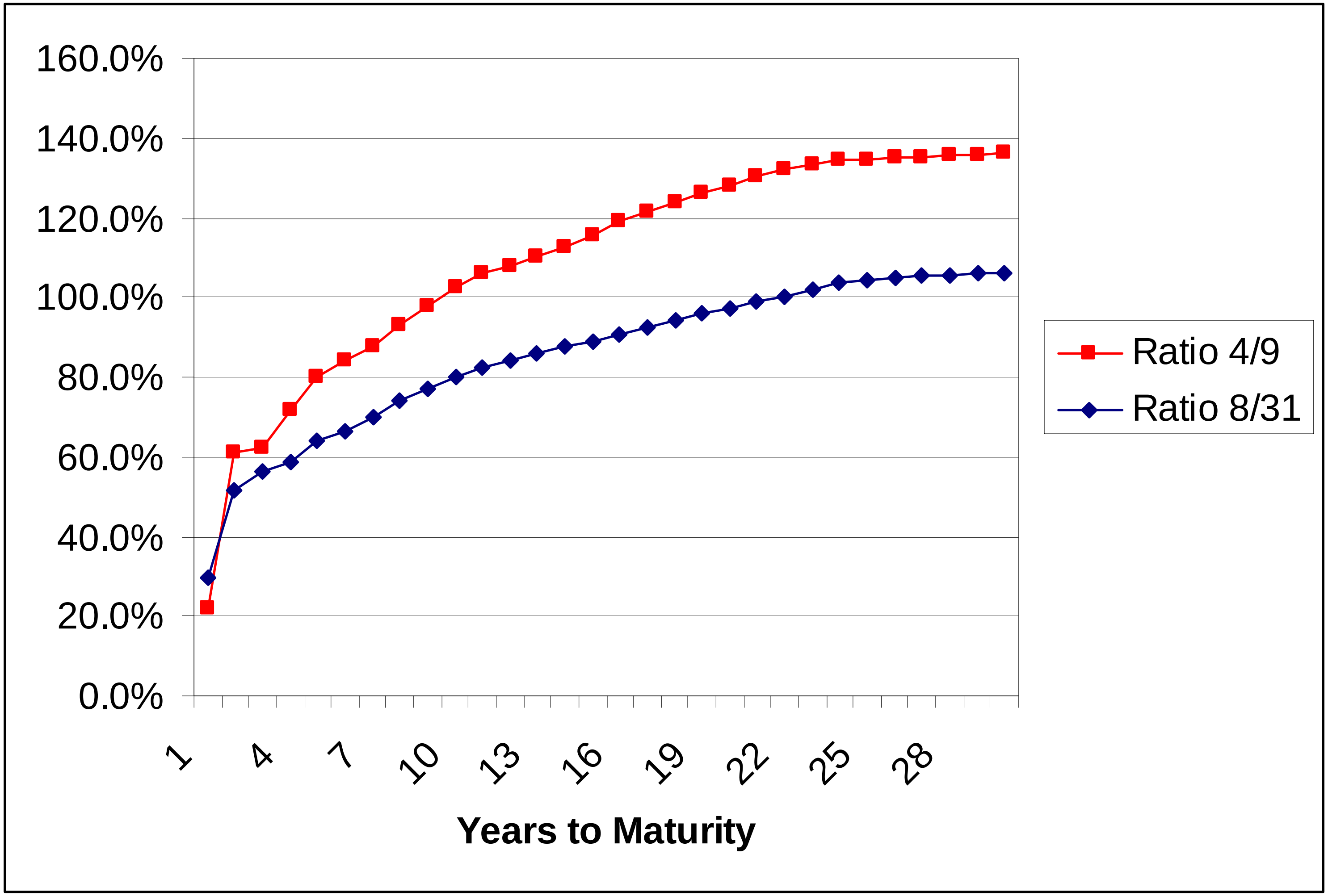
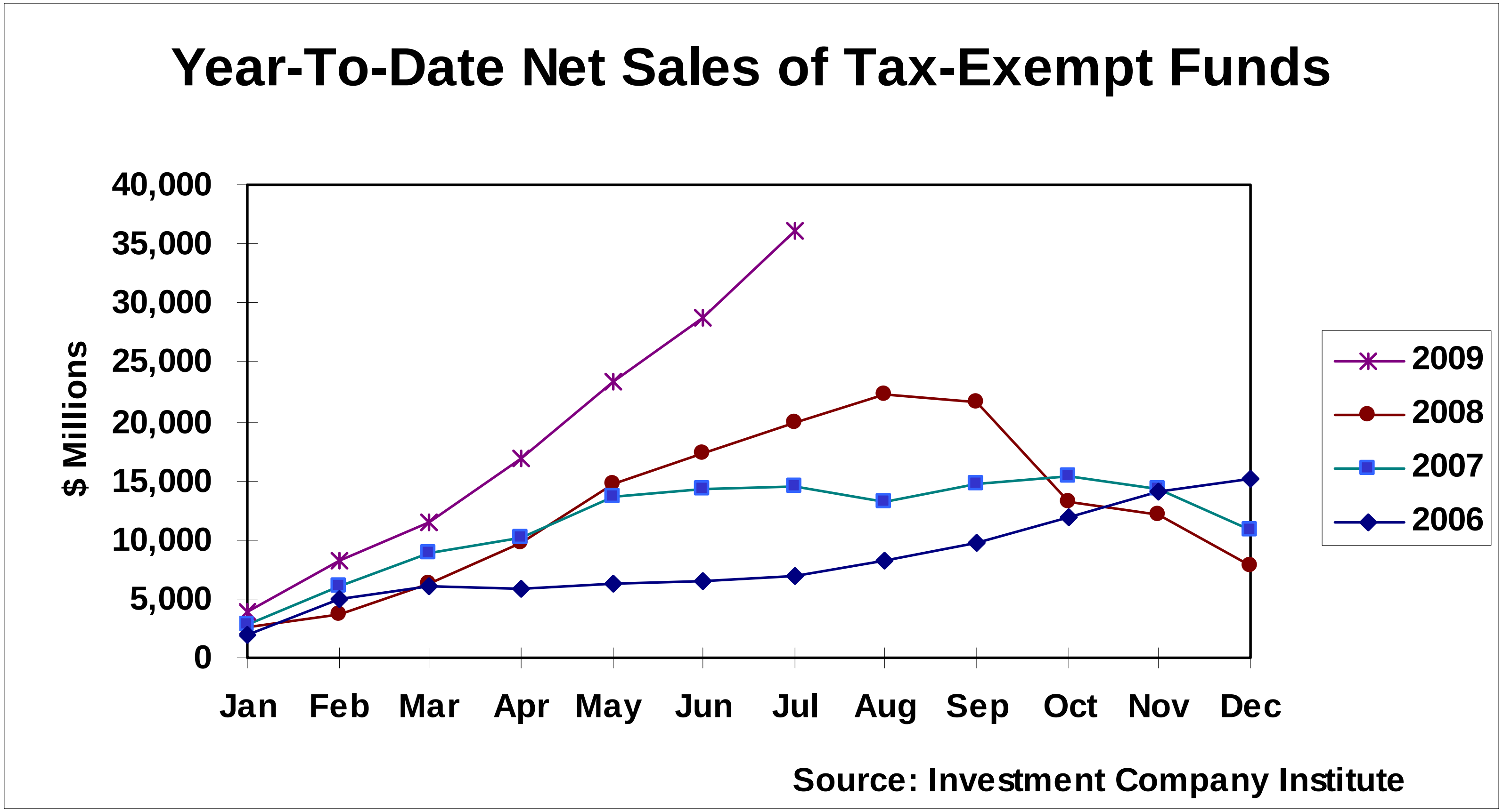


Tax-Exempt and Taxable Yields



Strong Demand for Municipals



Build America Bonds

Two Types:

- Tax Credit. Goes to investor
    - Include tax credit and interest in gross income
    - Unlike other tax credit bonds that pay no interest.
    - Can be passed through by mutual funds.
- Direct Pay. Goes to issuer

Issuer chooses which type.

Credit equals 35% of interest paid.

Build America Bonds

Restrictions:

•Must be sold in 2009 or 2010.

•Must qualify for tax-exemption under section 103 of IRC.

•No bonds for private activities (including 501(c)(3) bonds for hospitals and private colleges).

•Direct pay bonds must be used for capital expenditures.

•Only de minimis premium allowed.

Build America Bonds

Ideal candidates for BABs:

•Long maturities (where tax-exempt rates are highest relative to taxable rates).

•Term maturities of over $250 million (to qualify for Barclay’s Aggregate Index).

Build America Bonds

Why are tax credit bonds not appealing to investors?

Why are tax credit bonds less appealing to issuers?

Will Congress reauthorize Build America Bonds?

Build America Bonds

Why are tax credit bonds not appealing to investors?

- Tax-exempt mutual funds report yield according to SEC rules.
- Only tax-exempt income can be included in the calculation.
- Tax credit bonds produce taxable income, which is excluded.
- Tax treatment is complicated; credit is taxable income.
- Why create reporting process for a type of bond that may not be issued after 2010?

Build America Bonds

Why are tax credit bonds not appealing to issuers?

- Higher issuer cost because tax credit is included in taxable income.
- For someone in 35% tax bracket, taxable income = 135% of interest income.
- Rate paid by issuer is 74.1% of taxable rate (1/1.35 = 0.741)
- With direct pay bonds, net cost to issuer is 65% of interest paid.

Build America Bonds

Rate on tax credit bond x 1.35 = fully taxable rate.

Rate on tax credit bond = fully taxable rate / 1.35

Rate on tax credit bond = fully taxable rate x 0.7407.

Build America Bonds

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If issuer would pay 7% on $100,000 taxable,

It would pay 5.20% on tax credit bond

Investor's net after-tax income:

$5,200	Interest on bond (5.2% of $100,000)
+$1,820	Tax credit (35% of $5,200)
-$2,457	Tax liability (35% of 1.35 x $5,200)
$4,563	After-tax income

$4,463 / $7,000 = 65%.

Build America Bonds

Should tax-exempt market be priced to equal net interest cost of direct-pay BABs?

No, since the ratio of tax-exempt to taxable yields increases with longer maturities.

Build America Bonds

Ratio curve reflects:

•Longer maturities of municipals versus taxables.

•Redemption options on municipal bonds

•Credit concerns greater for longer maturities

•Uncertainty over future tax rates.

•Tax-deferral by accounts that hold long taxable bonds.

Benefit of Tax Deferral

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$100,000 invested for 30 years, earning 7% per year, which is reinvested.

At end of 30 years:

$100,000	original principal
$661,226	interest earned
$761,226	
-$231,429	Taxes (0.35 x $661,226)
$529,797	

Rate of Return = 5.72%

($529,797 / 100,000)^(1/30) = 1.0572

NUVEEN Investments

Benefit of Tax Deferral

5.72% after-tax return is

81.6% of pretax return of 7.00% (5.72 / 7.00 = 0.816)

Implied effective tax rate: 18.4% (100.0% - 81.6%)

Benefit of Tax Deferral

Number of Years	Ending Value	Tax Liability	After-Tax Value	After-Tax Rate	After-Tax Ratio	Implied Tax Rate
1	107,000	2,450	104,550	4.55%	65.0%	35.0%
2	114,490	5,072	109,419	4.60%	65.8%	34.2%
5	140,255	14,089	126,166	4.76%	68.0%	32.0%
10	196,715	33,850	162,865	5.00%	71.4%	28.6%
15	275,903	61,566	214,337	5.21%	74.5%	25.5%
20	386,968	100,439	286,529	5.40%	77.2%	22.8%
25	542,743	154,960	387,783	5.57%	79.6%	20.4%
30	761,226	231,429	529,797	5.72%	81.6%	18.4%

Benefit of Tax Deferral

Years to Maturity	Muni / Treasury	After-Tax Ratio
2	77%	66%
10	81%	71%
30	88%	82%

Build America Bonds, after 2010

Will Congress want to continue authorizing BABs after 2010?

- If every holder of BABs paid taxes at the 35% rate, then taxes received would equal subsidy paid.
- Many BABs have been bought by pension funds and foreign investors.
- Tax revenue generated will be less than payments to issuers.
- Payments will be an explicit expenditure in the budget for many years to come.

Build America Bonds, after 2010

Congressional Budget Office report proposed: “replace the tax exclusion for interest income on state and local bonds with a tax credit.”

•Does not include option for issuer to retain the credit as a direct payment.

•Credit rate “would probably be lower than the credit rate included in ARRA.”

•Congress could adjust the size of the credit depending on the purpose for which the bonds are sold.

Build America Bonds, after 2010

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- If issuer can retain the credit, then the bonds can be held in foreign and tax-deferred accounts.
- If tax credits can be separated from the bonds, then the bonds can be held in foreign and tax-deferred accounts.
- If tax credits can only be taken by the holder of the bonds, then demand from people in higher tax brackets will be reduced, resulting in higher interest costs for issuers.
- 77% of tax-exempt income received by taxpayers with AGI > $100,000, and 61% by those with AGI > $200,000.

Build America Bonds, Links

- Nuveen reports:
  - The American Recovery and Reinvestment Act:
  - http://www.nuveen.com/Home/Documents/Default.aspx?fileId=43483.
  - Build America Bonds:
  - http://www.nuveen.com/Home/Documents/Default.aspx?fileId=45045
  - BABs and the Efficiency of Tax-Exemption
  - http://www.nuveen.com/Home/Documents/Default.aspx?fileId=45188
- Rockefeller Institute, "What Will Happen to State Budgets When the Money Runs Out?" February 19, 2009
  - http://www.rockinst.org/pdf/government_finance/2009-02-19-What_Will_Happen_to.pdf

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