

Does G.O. Spell Go?

By reading headlines over the past year, one could easily conclude that navigating the municipal bond market is like driving through a busy Manhattan intersection where dodging traffic while avoiding potholes can be a near death experience. Simply because the traffic light turns green does not mean it is safe. The same can be said about the municipal bond market. As we seek to protect our clients' capital and add value, we must avoid obligors that risk impairment and securities that fail to offer attractive return potential.

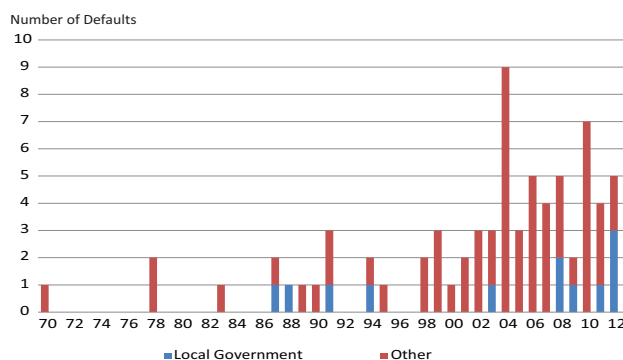
We relish the wide variety of issuers and bond structures in the municipal market. There are over 50,000 issuers of municipal bonds, but virtually all bonds fall into two main categories: General Obligation (GO) Bonds and Revenue Bonds. GO bonds are issued by states and local governments which include cities, counties, and school districts. These bonds are backed primarily by an issuer's taxing authority and are generally full faith and credit obligations. Revenue bonds are secured only by specific revenue streams, such as sales tax, or the revenues of a specific project or enterprise (such as a hospital or airport). In this commentary, we will explore the local government sector and describe how we cull the thousands of issuers to uncover well-secured bonds, while avoiding troubled obligors.

Most municipal investors view GO bonds as safe and secure. Large-scale municipal GO defaults have historically been rare, so this is not illogical from an investment standpoint. We would attest that as municipal investors, and as residents in the New York metro area, taxing authority is a powerful government finance tool, so the historically low GO default rate is not a surprise.

Until recently, defaults in the local government sector were associated with political corruption, chronic financial mismanagement, and superfluous public projects. In 2008, Jefferson County, Alabama defaulted on its debt because of a misuse of credit derivatives and massive cost

overruns for a sewer upgrade project. A failed incinerator project with dubious economics drove Harrisburg, Pennsylvania into default during 2009. In 2012, the Minnesota city of Vadnais Heights defaulted on its lease obligations because officials had a change of heart on whether public funds should be spent on a sports complex.

Number of Municipal Defaults Since 1970



Source: Moody's Investors Service
Data as of December 31, 2013

In contrast to these examples, the recent bankruptcy filings by Stockton and San Bernardino, California, and Detroit, Michigan represent examples of long-term struggles to achieve fiscal sustainability. These cities suffered from poor fiscal discipline, and they are now saddled with large debt and unaffordable pension obligations that accumulated over decades of generous benefit provisions. For example, the City of Stockton consistently (and irresponsibly) doled out generous wage and benefit increases to its unionized workforce that exceeded both the rate of inflation and the natural revenue growth allowed under its property tax levy cap.

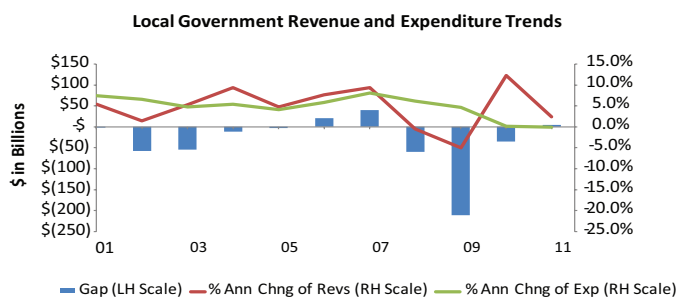
Recently, the growing number of municipal bankruptcies reminds us that the GO pledges of local governments are not invincible. However, the municipal market has viewed these examples as idiosyncratic and continues to regard the GO pledge as one of the strongest and safest available. We do not. Although local government GOs remain a veritable green light investment for many municipal

buyers, we must ask ourselves, does G. O. really spell go?

To answer this question, we look past market perceptions and assess the strength of the GO pledge on its own merits, and its value in the marketplace. The GO pledge comes in two primary forms, an unlimited tax GO (ULTGO) and a limited tax GO (LTGO). ULTGO bondholders enjoy the benefit of the full taxing authority of the issuing entity. If an issuer of an ULTGO has insufficient funds for debt service, it is required to raise taxes to cover its obligations. An LTGO pledge is statutorily limited by rate or tax amount, thus making holders of this class of debt somewhat less secure.

The fundamental quality of GOs relies on both a government's ability and willingness to pay their obligations. To gauge this quality, we assess a variety of factors including the health of the issuer's tax base and its economy, the flexibility to adjust revenues and expenditures, financial reserves, and the reasonableness of its debt burden and other long-term obligations. Underpinning all these factors is the ability of officials to effectively manage their resources and maintain a sound financial profile.

Stories of large budget gaps and severe spending cuts have dominated local town hall meetings over the past few years and have permeated the national and local conversation. These stories will likely continue as many of these problems are structural in nature. As a result of



Sources: 2001-2011 Annual Surveys of State & Local Government Finance, U.S. Census Bureau and BBH Analysis

Note: The U.S. Census Bureau 2011 data is the most current available as of June 2014. The U.S. Census Bureau has a two year lag in reporting results of Annual Surveys of State and Local Government Finances.

successful taxpayer relief initiatives in previous decades, many local governments, especially those in California, Michigan, and New Jersey, are limited in their ability to raise property taxes. Fallout from the Great Recession

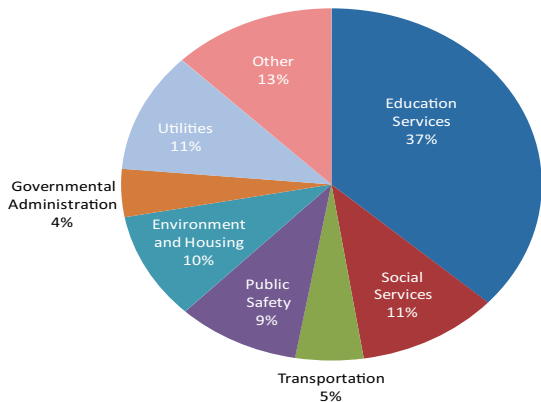
such as falling housing values, as well as state and federal aid reductions, further constrain their revenue bases. On the expenditure side, salary and benefits often have contractual increases that exceed the rate of inflation. Despite five years into the recovery phase, many local government budgets today remain smaller than their pre-recession levels. This has left budget officials with constrained resources and the increasingly difficult task of allocating between a growing set of spending priorities.

Despite these obstacles, the majority of local governments have successfully balanced their budgets since 2008 by reducing spending, downsizing their workforces, and raising taxes to the extent possible. The majority of issuers have resisted many of the “one-time” gap-closing measures such as extension of debt maturities, the privatization of municipal assets, and the rapid depletion of reserves. The adjustment of a government's cost structure down to a level consistent with smaller revenue streams has been both politically and financially difficult. Attaining long-term structural balance often means implementing politically difficult tax increases and engaging in contentious battles with organized labor for layoffs, reduced wages and benefits, and pension reform. We understand the many challenges politicians face when they have to ask their constituents to pay more in taxes in return for fewer services — arguably, a lose-lose proposition, at least in the short term. Nevertheless, when we underwrite a credit, we look for management teams that are willing to undertake such arduous tasks which are key to long-term financial stability. Additionally, we look for obligors that have healthy levels of financial reserves to provide a margin of safety against short-term revenue downturns and give management time to phase in larger spending reductions. This is especially true for local governments since they do not possess the wide range of financial flexibility like state governments and are often the victims of gap closing measures at the state level. Despite the drumbeat of headlines detailing one challenged municipality after another, we are able to identify a broad universe of issuers that manage their finances in a responsible manner and that offer safety and security for bondholders.

Hope is not a fiscally responsible strategy, and those municipalities which opt for quick fixes are only postponing painful decisions. Many issuers have recently chosen to rely on pension holidays and the issuance of

bonds to fund pension contributions and budget deficits, hoping that better economic conditions down the road will spur revenue growth and solve their budget problems.

Local Government Expenditures - Where to Cut?



Sources: U.S. Census Bureau, 2011 Annual Surveys of State and Local Government Finances and BBH Analysis
 Note: The U.S. Census Bureau 2011 data is the most current available as of June 2014. The U.S. Census Bureau has a two year lag in reporting results of Annual Surveys of State and Local Government Finances.

Unfortunately, the current recovery has failed to generate robust revenue growth as has been typical of other economic rebounds. Local governments that failed to realign their cost structures during the recession find that balancing their books now is a Herculean task, requiring major cuts to essential services. With quick fixes exhausted and cash rapidly running out, these governments have had to make real and permanent changes to their expenditures and long-term liabilities in a relatively short time. Many obligors were able to implement structural changes to stem the decline in their fundamentals. For a select few, such as Stockton, San Bernardino, and Detroit, even the biggest changes were not enough, leaving bankruptcy as the last remaining option.

It is inherently hard to predict whether a government will have the political will (and public mandate) to make the hard choices to avoid fiscal distress. It is even harder to predict whether a distressed obligor will impair its bondholders in favor of sparing its pensioners or taxpayers. We approach our credit work with a well-defined set of criteria and we demand a margin of safety in all of our investments. We simply avoid obligors that do not meet our standards and only invest in strong, resilient, and well-secured securities. Of critical importance to our analysis are financial flexibility, healthy reserves, and diversified revenues from resilient tax bases. These factors help protect local governments from inevitable swings in

their revenues. We look for governments that have a history of making spending adjustments to maintain reasonable budgetary balance. We are also careful to stop at any red lights such as low liquidity, questionable capital projects not essential to government functions, large pension liabilities with a history of underfunding, worrisome population declines, limited budget flexibility, and large budget gaps with no feasible corrective action plans. Examples of these red lights include hockey arenas in the middle of the desert, selling off items from the Wild West Museum for liquidity, and repeatedly budgeting for sales tax increases that never materialize. Our selection process leads us to hold durable obligors that we believe are unlikely to be impaired even during adverse economic times.

In addition to our stringent fundamental criteria, our securities must offer attractive compensation. Because of the historically strong standing of the GO pledge, compelling opportunities in local government GO securities have often been limited. Consequently, we have consistently found a wider range of opportunities in Revenue bonds for the past several years, notably in health care and airport-related obligors. Not only are these securities more attractive from a valuation standpoint, but they also come with added bondholder protections that prevent overleveraging and ensure timely rate increases. In addition, these obligors are typically more removed from the political battles waged annually during budget season. Within our universe of investments, our efforts have been highly skewed toward investing in Revenue bonds. For the GO exposures we do have, they are typically concentrated in state-related obligations, which have a wider breadth financial resources and flexibility than their underlying localities. Absent a change in investor risk preferences for GO securities, we expect this to remain the case.

Does G. O. spell go? To us it is more of a yellow light – we proceed with caution.

Gregory Steier
 Managing Director

Head of Tax-Exempt Portfolio Management



Dora Lee
 Assistant Vice President
 Municipal Credit Research



The investment objective of the BBH Intermediate Municipal Bond Fund (the "Fund") is to protect investors' capital and generate attractive risk-adjusted returns. The BBH Intermediate Municipal Bond Fund is a new mutual fund with a limited operating history.

BBH, a New York limited partnership, was founded in 1818 and provides investment advice to registered mutual funds through a separately identifiable department (the "SID"). The SID is registered with the U.S. Securities and Exchange Commission under the Investment Advisers Act of 1940. BBH acts as the Fund Administrator and is located at 140 Broadway, New York, NY 10005. Shares of the Fund are distributed by ALPS Distributors, Inc. and is located at 1290 Broadway, Suite 1100, Denver, CO 80203.

Additional information regarding the Fund including investment positions is available upon request.

For more complete information, visit www.bbhfunds.com for a prospectus. You should consider the fund's investment objectives, risks, charges and expenses carefully before you invest. Information about these and other important subjects is in the fund's prospectus, which you should read carefully before investing.

The views expressed are as of June 2014 and are a general guide to the views of BBH. The opinions expressed are a reflection of BBH's best judgment at the time this publication and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed.

This publication is a general guide to the views of Brown Brothers Harriman & Co. and is provided to recipients who are classified as Professional Clients and Eligible Counterparties if in the European Economic Area ("EEA"), solely for informational purposes. This does not constitute legal, tax or investment advice and is not intended as an offer to sell or a solicitation to buy securities or investment products. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code or for promotion, marketing or recommendation to third parties. This information has been obtained from sources believed to be reliable that are available upon request. This material does not comprise an offer of services. Any opinions expressed are subject to change without notice. Unauthorized use or distribution without the prior written permission of BBH is prohibited. This publication is approved for distribution in member states of the EEA by Brown Brothers Harriman Investor Services Limited, authorized and regulated by the Financial Conduct Authority (FCA). BBH is a service mark of Brown Brothers Harriman & Co., registered in the United States and other countries. © Brown Brothers Harriman & Co. 2014. All rights reserved. 06/2014.