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Developments in the Municipal Bond Markets

By Dennis P. Hannigan, CFA, Senior Portfolio Manager

As our economy struggles to fully recover from the recession, more states and local municipalities are experiencing financial stress. Concerns are being raised about their ability to repay municipal bonds as they come due. While the vast majority of our municipal bond holdings are very high quality assets, we are proactively reviewing our existing holdings and have implemented more stringent criteria for new purchases.

Our approach to managing risk in our municipal bond holdings includes the following:

- Diversify by state and municipality while avoiding large, concentrated holdings in each portfolio.
- Avoid general obligation bonds from states that we consider high risk. This list continues to grow (AL, AZ, CA, CT, FL, IL, LA, MI, MS, NJ, NV, NY, OR, PA, RI).
- Buy bonds in the highest underlying rating categories (generally AA or AAA; A in certain circumstances) and with stable or improving outlooks, and for the most part, ignore bond insurance.
- Buy general obligation and essential services (water and sewer, etc.) revenue bonds.
- Avoid higher risk issuers such as hospitals, nursing homes, convention centers, development projects and certain state and local agencies.
- Avoid smaller issue sizes which are generally less liquid (harder to sell).
- Favor shorter maturity bonds, but continue to ladder bonds by maturity so that if interest rates rise, the portfolios will have good cash flow to reinvest at these higher rates.

In addition, we are reviewing our existing holdings to identify those that would not meet these enhanced guidelines. For these bonds we are performing additional research and assessing the prices available in the market. We are proactively selling bonds where we identify any deterioration in credit quality or if we have other concerns about the risk of the underlying credit.

We would not be surprised to see an increase in the number of credit rating downgrades in the municipal market over the next several years as borrowers work to improve their financial condition. Historically, actual defaults on municipal bonds are exceedingly rare. Municipal bonds continue to be an asset class that serves to provide reliable, steady cash flow and to enhance the total return of a portfolio while reducing the overall volatility. For example, while common stocks have stronger returns over the very long-term, over the last ten years the rates of return on municipal bonds has been well in excess of those generated by the overall stock market.

Although the markets may be very volatile for the next couple of years, we continue to believe that high quality municipal bonds should be a core component of most taxable portfolios. Managed carefully, they will continue to provide dependable cash flow and attractive after-tax yields.

If you have any questions or concerns, please contact your portfolio manager. We welcome the opportunity to discuss your holdings and the steps we are taking to manage your assets.

January 2011

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