

Municipal Report

Who Holds Municipal Bonds?

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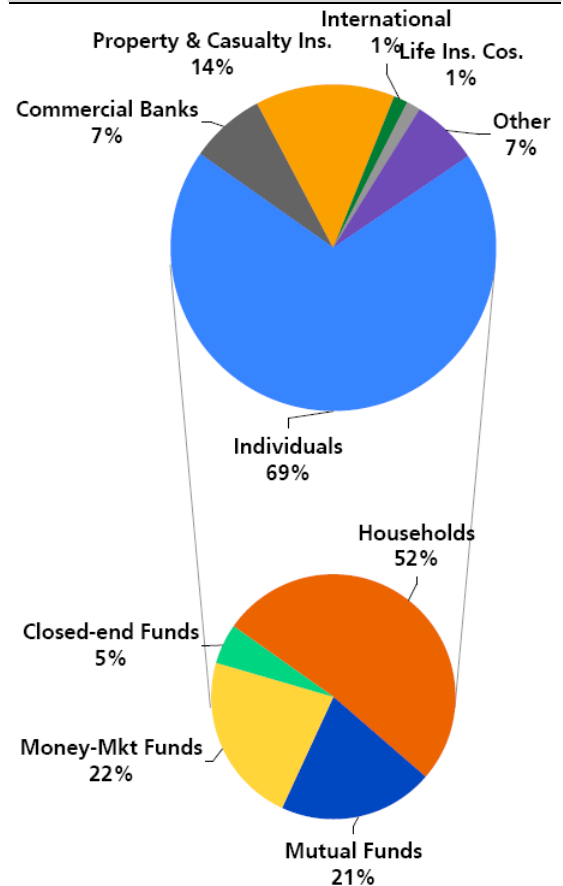
On March 15, the Federal Reserve reported on a preliminary and seasonally unadjusted basis that the municipal market has just over \$2.4 trillion in outstanding debt as of December 31, 2006. Over the past decade, households have been and continue to be the largest holders of municipal debt, totaling \$860.6 billion directly as of the end of 2006. Indirectly, through money market funds, closed-end funds¹, and mutual funds, individuals hold another \$370.0 billion, \$89.7 billion, and \$343.0 billion, respectively, for a total of 69% of outstanding paper. While this percentage has gone down from 75% in 2002, on a dollar basis the amount of municipal debt that individuals own directly and indirectly has grown annually over the past nine years.

Rounding out the top holders of municipal debt are property and casualty insurance companies (P&C) at \$335.2 billion (14%) and commercial banks at \$180.2 billion (7%). Over the past nine years these two holders consistently followed households as the largest holders of municipal paper. On a percentage basis, their market holdings have risen annually since 2002.

The shift in holdings as a percentage among these traditional buyers is not a major concern in itself, but the growth in recent years by non-traditional buyers, such as tender option bond programs, hedge funds, and international investors, does raise some issues. They are not traditional buy and hold customers and it appears that over the past few years they have supported the long-end of the curve. Therefore without a thorough understanding of these non-traditional buyers' long-term goals and philosophies, long municipals may be exposed to additional volatility risk if these buyers were to unexpectedly change direction and leave the municipal market.

Holdings of Municipals²

Individuals hold 69% of outstanding municipal bonds



Source: The Federal Reserve Bank, 31 December 2006

¹ In the 21 March 2007 Municipal Report, we did not include closed-end funds as an "Individual" holding. This inclusion increases the Individual holdings by 4% in 2006, and 5% in 2002, hence the change in figures from the original report.

² Percentages may not total 100% due to rounding.

Statement of Risk

Municipal bonds: Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond's sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor's total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Appendix

Terms and Abbreviations	
Terms / Abbreviation	Description / Definition
GO	General Obligation Bond
TEY	Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)
MMD	Municipal Market Data

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Appendix

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