Investment
Perspectives
June 2013

Municipal Insights

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- Moody's recent study highlights municipal vs. corporate default rates
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Market Commentary

May Muni Showers

Bond prices began to slip early in May on a better-than-expected April employment report, but that was just the beginning of a fairly meaningful adjustment in rates last month. Mixed signals from members of the Federal Reserve Board, including Chairman Bernanke, as to when the pace of their $85 billion monthly bond purchases may slow, created additional anxiety and upward pressure on yields. The 10-year Treasury yield jumped nearly 50 bps and 10-year tax-exempt yields rose 40 bps. Although tax-exempts outperformed Treasurys, only the shortest maturities and floating-rate securities offered meaningful protection.

> Investors are focused on shorter and intermediate segments of the curve to protect against rising rates.

The tax-exempt yield curve steepened as rates rose. Two-year municipal yields anchored the front end and were unchanged for the month, while 5- and 30-year yields rose 20 and 40 bps, respectively. In addition to a steepening Treasury curve, tax-exempt fund flows also influenced the municipal curve. Fund flows turned negative once again, after a brief respite, with longer-term and high yield funds losing the most. Year-to-date total fund flows remain positive, but investors are focused on shorter and intermediate segments of the curve to protect against rising rates.

Resurrection of Bond Insurance

It is fair to say the financial crisis of 2008 changed the monoline bond insurance industry forever. In 2007 over one-half of all new issues were wrapped by one of the many then AAA rated insurers (MBIA, Ambac, Assured Guaranty, FGIC, XLCA, and CIFG). Of these, only Assured Guaranty Municipal Corp (AGM) survived, albeit bruised by a series of rating downgrades (now A2/AA-), but nonetheless was able to continue writing new business through the crisis to the present. As a result, the insured market penetration fell to roughly 5% of total new supply, yet that percentage appears poised to rise once again due to recent developments. It is very unlikely to approach pre-crisis levels, but it is possible, insurance could capture 10 – 15% of primary market issuance again.

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First, the earnings for AGM have been solid and recent litigation has been favorable. They recently reached a settlement with UBS and are to receive $358 million due to offset mortgage defaults and AGM established a loss-sharing arrangement with UBS going forward on future mortgage-related defaults. Similarly, National Public Finance (“National”), the municipal subsidiary of MBIA, reached a settlement with Bank of America for $1.7 billion, also covering mortgage-related litigation. In addition, all litigation due to the split of their business lines (muni and non-muni) back in 2009 has been settled; both very favorable outcomes that led to ratings upgrades from Moody’s and S&P, to Baa1 and A, respectively. While not yet ready to begin underwriting new business, National hopes to do so before long.

Finally, a new insurer, Build America Mutual (BAM), has emerged with a unique business model. They plan to insure only “traditional” municipal debt, specifically general obligation and essential service revenue bonds. But also, as a mutual insurer, they are not dependent upon the financial markets for capital as are the other insurers. Instead, after receiving $500 million of permanent capital to get started, they will be funded by their policy holders, which are the very municipalities they insure. The rating agencies have blessed their business model with an AA rating (S&P). As of May 31, BAM had already insured 251 transactions with a total par value of nearly $1.9 billion, competing aggressively with Assured Guaranty for market leadership. Time will tell, of course, but we believe the insurers are here to stay as it appears the demand from issuers and investors alike is sufficient.

Market Commentary *(continued from page 2)*

Who Needs Insurance Anyway?

To help answer that question we turn to the recently released Moody's Municipal Default Study, covering the period from 1970 – 2012. While some may believe this period is unrepresentative of the long-term risks for the municipal market, the facts simply do not support this view. Over this 43-year period, the U.S. experienced seven recessions, including the most recent, which was the deepest since the Great Depression, eight different U.S. Presidents (four Republicans and four Democrats), two of whom were impeached or resigned, four wars (not counting The Cold War or the ongoing War on Terror), and a changing monetary policy that caused Treasury yields to rise above 15% and back down below 2%.

> What the study illustrates is the resiliency of municipalities through very challenging periods.

This was as varied a period economically, financially, politically, and militarily as one could imagine. Yet, through it all, municipal default rates were extremely low, both nominally and relative to similarly rated corporate default levels. What the study illustrates is the resiliency of municipalities through very challenging periods.

Moody's Cumulative Default Rates
Average over the Period 1970 – 2012

Municipal vs. Corporate Issuers			
Rating	Municipal	Corporate	Corp/Muni Default Ratio
Aaa	0.00%	0.50%	N/A
Aa	0.01%	0.92%	92:1
A	0.05%	2.48%	50:1
Baa	0.30%	4.74%	16.1

Source: Moody's

The difference between municipal and corporate default rates is striking. The cumulate default rate average for A and BBB rated corporate debt was 50x and 16x higher, respectively, than similarly rated municipal debt.

Too often investors overlook the favorable default relationship between the municipal and corporate markets. We consistently see investors willing to accept the default risk in "household" corporate names in the A rating category, for example, yet are unwilling to accept similarly rated municipal debt. To help illustrate this point, some common corporate A rated names at the start of the alphabet are: Abbott Labs (A1/A+), Allstate Insurance (A3/A-), American Express (A3/BBB+), Anheuser-Busch (A3/A), and AT&T (A3/A-). A diversified list of excellent companies, to be sure. Yet, the Moody's study would suggest that all of these corporations, despite their long history, are multiple times more likely to default over the life of a bond than are, for example, any of the major airports in the U.S. that are also A rated. An investor could travel from Miami to Atlanta, Dallas, Chicago, Denver, Phoenix, Los Angeles, and San Francisco without ever having touched ground in anything less than an A rated airport. Knowing how much lower the default expectations are for their "airport" portfolio over their corporate portfolio should allow this investor to rest comfortably the entire trip! Not to mention the similarly strong ratings of those cities, or the municipal utilities that serve the residents, or the schools that educate their students. After all, A's look good not only on a student's report card, but also in their parents' municipal portfolio!

> Too often investors overlook the favorable default relationship between the municipal and corporate markets.

What the data from the Moody's study suggests is there is little need for default protection for a diversified, investment grade municipal portfolio. Insurance can, however, provide some benefit for investors. For some retail investors primarily, simply having an additional guarantee provides added peace of mind and may minimize the need to monitor the underlying credit as closely as if it were not insured. Perhaps the greater benefit, however, is the liquidity an insured bond can offer investors during periods of illiquidity and volatility. For these reasons, and others, we believe the entire municipal market benefits from a modest level of insured representation and we welcome the resurgence of the industry. ◀

Credit Updates

Airports: Taking Off?

U.S. air travel is expected to be up this summer with an estimated 209 million people taking to the skies. Packed planes and crowded airports may be unpleasant for travelers but positive for airport credit quality. In fact, Moody's revised to stable their outlook for the U.S. airport sector following five consecutive years of negative outlooks. According to Moody's, as airport traffic growth continues to outpace other sectors of the economy, airport credit-metric gains, which became evident last year, are likely to continue their positive trend.

The U.S. air transportation system counts almost 500 commercial service airports, 29 of these are classified by the FAA as large and 36 are classified as medium hub airports; together the large and medium hubs account for almost 90% of enplaned passengers and 94% of total airport debt. These major commercial airports play a critical role in the U.S. economy, serving the needs of business travelers, leisure travelers, and cargo-transport providers alike. For this reason, we categorize airport debt as essential service revenue bonds.

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Credit quality is measured by several factors, including the strength of the local service area, the amount of origination and destination (O&D) passengers, the percentage of international traffic, a diverse carrier mix, competitive cost position, rates and charges to the airlines, rents and fees charged to tenants and passengers, capital-program requirements and existing debt, and liquidity. Despite the recent challenges of a weak economy, airport credit quality remains relatively strong with the majority of ratings clustered in the A category. According to Standard & Poor's, 70% of their general airport-revenue bond ratings are A, 15% are AA, and 15% are BBB.

While the airport sector will continue to face general economic and political risks, such as consolidating/restructuring air carriers and the capital-intensive nature of airport management, air travel is a priority for our economy, which is supportive of stable-to-improving airport credit trends. ◀

Performance and Strategy

Fund Performance as of May 31, 2013

				As of May 31, 2013 (%)		Returns as of May 31, 2013 (%)					Expense Ratios (%)[1]	
Fund / *Index*	Share Class	Inception Date	Ticker	1 Month	YTD	1 Year	3 Year	5 year	10 Year	Since Inc.	Gross	Net
BMO Ultra Short Tax-Free Fund	I	09/30/09	MUISX	-0.02	0.40	1.08	1.55	N/A	N/A	1.63	0.38	0.31
BMO Ultra Short Tax-Free Fund	Y	09/30/09	MUYSX	0.06	0.40	0.93	1.30	N/A	N/A	1.41	0.63	0.56
Blended Benchmark[2]				*0.01*	*0.18*	*0.38*	*0.54*	*1.09*	*1.68*			
BMO Short Tax-Free Fund[3]	I	11/29/12	MTFIX	-0.38	1.05	N/A	N/A	N/A	N/A	1.80	0.78	0.40
BMO Short Tax-Free Fund[3]	Y	11/29/12	MTFYX	-0.39	0.99	N/A	N/A	N/A	N/A	1.73	1.03	0.55
Barclays Short (1-5 Year) Municipal Index				*-0.13*	*0.61*	*N/A*	*N/A*	*N/A*	*N/A*			
BMO Intermediate Tax-Free Fund[4]	I	12/27/10	MIITX	-1.10	0.33	3.25	5.41	6.00	4.40	4.80	0.45	0.45
BMO Intermediate Tax-Free Fund	Y	02/02/94	MITFX	-1.12	0.33	3.05	5.34	5.97	4.38	4.79	0.70	0.55
Barclays U.S. 1-15 Year Blend Municipal Bond Index				*-1.09*	*0.13*	*2.28*	*4.60*	*5.20*	*4.29*			

Other Benchmarks as of May 31, 2013

	As of May 31, 2013 (%)		Returns as of May 31, 2013 (%)			
	1 Month	YTD	1 Year	3 Year	5 year	10 Year
Barclays U.S. 1-10 Year Blend Municipal Bond Index	*-0.91*	*0.27*	*1.90*	*4.02*	*4.77*	*3.98*
Barclays U.S. Municipal Bond Index	*-1.22*	*0.15*	*3.05*	*5.49*	*5.70*	*4.68*

Source: Barclays and BMO Global Asset Management

Performance data quoted represents past performance and past performance is not a guarantee of future results. Investment returns and principal value will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Mutual fund performance changes over time and current performance may be lower or higher than what is stated. To receive the most recent month-end performance, call 1-800-236-3863. Performance quoted does not reflect the effect of a 2% redemption fee which is imposed on any shares redeemed or exchanged within 30 days, except for the BMO Ultra Short Tax-Free Fund. Returns are pre-tax. For more information about performance, please contact your investment professional. Total returns for periods of one year or less are cumulative.

[1] Net Expense Ratios reflect contractual fee waivers and/or expense reimbursements made by BMO Asset Management Corp., the investment adviser (Adviser). The Adviser may not terminate these fee waivers and/or expense reimbursements prior to December 31, 2013 unless the investment advisory agreement is terminated. Without these contractual waivers, the Funds' returns would have been lower. Please see the prospectus for more information.

[2] The Blended Benchmark: 50% Barclays 1-Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index

[3] The Gross Expense Ratios for this Fund are based on estimated expenses for the current fiscal year because it is a new Fund.

[4] Performance data quoted prior to Inception of Class I of the Fund is the performance of the Fund's Investor Class (Class Y), not adjusted for any differences in the expenses of the classes.

Strategy

We, like the Fed, remain "data dependent." Until the economic data confirms that further caution is warranted, our portfolios and funds will remain neutral-to-short across all strategies. With a steeper curve following May's yield adjustments, we continue to favor intermediate maturities for their roll potential as a source of return. And, although credit spreads came under modest pressure in May, we expect demand for mid-tier quality issues to remain strong. Therefore, we continue to look for credit opportunities, particularly in A rated debt when adequately compensated for the risk. The technical backdrop for the tax-exempt market is favorable in June due to heavy cash roll-off. We expect at least a portion of the significant June coupon payments as well as called and matured bond proceeds to find their way back into the tax-exempt market, helping to strengthen demand. ◀

Strategy Overview

Duration: Neutral to modestly short across all strategies

Curve: Capture the roll-down among intermediate maturities

Credit: Overweight A and BBB rated issues

Sector: Maintain a revenue sector bias

Structure: High coupon, callable issues with significant premium protection ("cushions")

Data for the Journey

Valuation Data as of May 31, 2013

AAA Yields

		Change		
Year	Current	*1 Mo*	*3 Mo*	*1 Yr*
2	0.29%	*0.00%*	*-0.02%*	*-0.04%*
5	0.94%	*0.20%*	*0.17%*	*0.19%*
10	2.09%	*0.40%*	*0.28%*	*0.30%*
30	3.24%	*0.40%*	*0.33%*	*0.16%*

Source: InvestorTools® Perform

Cross-Market Values

	Current (1-Year Averages)	
Year	Muni/Treasury	Muni/Corporate
2	98% (121%)	77% (84%)
5	92% (102%)	74% (75%)
10	98% (101%)	85% (82%)
30	99% (100%)	89% (85%)

Source: InvestorTools® Perform and Bloomberg

Yield Curve Data as of May 31, 2013

Slope Changes

		Change		
	Current	*1 Mo*	*3 Mo*	*1 Yr*
Wkly-2's	0.18%	*0.10%*	*-0.01%*	*0.06%*
2-5's	0.65%	*0.20%*	*0.17%*	*0.19%*
2-10's	1.80%	*0.40%*	*0.30%*	*0.34%*
2-30's	2.95%	*0.40%*	*0.35%*	*0.20%*

Source: InvestorTools® Perform

Performance By Duration

Year	*1 Mo*	*3 Mo*	*1 Yr*
0-3	*-0.11%*	*0.26%*	*2.09%*
3-6	*-1.05%*	*-0.30%*	*3.51%*
6-10	*-2.32%*	*-1.57%*	*2.85%*
10+	*-3.12%*	*-2.55%*	*4.78%*

Source: Barclays Point

Credit Data as of May 31, 2013

Current Rating Spreads

	Current (1-Year Averages)	
Year	AAA-A	AAA-BBB
2	0.22% (0.26%)	0.77% (0.87%)
5	0.44% (0.52%)	1.25% (1.46%)
10	0.71% (0.70%)	1.33% (1.56%)
30	0.76% (0.70%)	1.29% (1.40%)

Source: InvestorTools® Perform

Performance By Quality

Rating	*1 Mo*	*3 Mo*	*1 Yr*
AAA	*-1.22%*	*-0.67%*	*1.85%*
AA	*-1.30%*	*-0.64%*	*2.63%*
A	*-1.31%*	*-0.53%*	*4.01%*
BBB	*-0.34%*	*-0.06%*	*4.63%*

Source: Barclays Point

BMO Funds Tax-Free Suite

Fund Name	**Ticker (Y Shares/I Shares)**
BMO Tax-Free Money Market Fund	MTFXX / MFIXX
BMO Ultra Short Tax-Free Fund	MUYSX / MUISX
BMO Short Tax-Free Fund	MTFYX / MTFIX
BMO Intermediate Tax-Free Fund	MITFX / MIITX

You should consider the Fund's investment objectives, risks, charges, and expenses carefully before investing. For a prospectus and/or summary prospectus, which contain this and other information about the BMO Funds, call 1-800-236-3863. Please read it carefully before investing.

BMO Asset Management Corp. is the investment adviser to the BMO Funds. **M&I Distributors LLC is the distributor.** BMO Funds are not marketed or sold outside of the United States.

Keep in mind that as interest rates rise, bond prices fall. This may have an adverse effect on the Fund's portfolio.

Interest income from Tax-Free Fund investments may be subject to the federal alternative minimum tax (AMT) for individuals and corporations, and state and local taxes.

All investments involve risk, including the possible loss of principal.

Barclays 1-10 Year Blend Municipal Bond Index is an unmanaged index of municipal bonds rated BBB or better with 1 to 12 years to maturity.

Barclays Capital U.S. Municipal Bond Index is an unmanaged index of a broad range of investment-grade municipal bonds that measures the performance of the general municipal bond market.

Blended Benchmark consists of 50% Barclays 1 Year Municipal Bond Index and 50% iMoneyNet Money Fund Tax Free National Retail Index. Money Fund Report Averages™ is an arithmetic average of performance for all money market mutual funds tracked within this category. Money Fund Report Averages™ is a service of iMoneyNet, Inc. (formerly IBC Financial Data). The Barclays Capital 1-Yr Municipal Bond Index is the 1-year component of the Barclays Capital Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa.

Barclays Short (1-5 Year) Municipal Index includes investment-grade tax-exempt bonds that are issued by state and local governments and have maturities of 1 to 5 years.

Barclays U.S. 1-15 Year Blend Municipal Bond Index is the 1-15 year Blend component of the Barclays Capital Municipal Bond Index, which is an unmanaged index composed of long-term tax-exempt bonds with a minimum credit rating of Baa and a range of maturities between 1 and 17 years.

Investments cannot be made in an index.

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