Investment Perspectives

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Municipal Insights

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Market commentary

Buy or sell? That is the question!

In his 1997 letter to Berkshire Hathaway Inc. shareholders, Warren Buffet offered a "short quiz." He wrote, *"If you plan to eat hamburgers throughout your life and are not a cattle producer, should you wish for higher or lower prices for beef? Likewise, if you are going to buy a car from time to time but are not an auto manufacturer, should you prefer higher or lower car prices? These questions, of course, answer themselves. But now for the final exam: If you expect to be a net saver over the next five years, should you hope for a higher or lower stock market during that period? Many investors get this one wrong."* Of course, the answer is, if you are a net buyer of anything, it makes sense to wish for the price to go down rather than up.

The same logic should apply to bonds as well, but it hasn't recently. Consider the demographics of the U.S. There are roughly 10,000 baby boomers retiring every day, a pace that will be maintained for the next 15 years. There are clearly many investors who are currently, or soon will be, net buyers of investments that produce supplemental income, like bonds. Yet, as bond prices have fallen over the last three months, investors have largely been sellers, rather than buyers. Redemptions from fixed income funds, particularly municipal funds, have been persistent. The selling of individual bonds in the secondary market by retail investors has also been steady. In our view, "Many investors (are) get(ting) this one wrong." Unless an investor is already invested at their maximum allocation to fixed income – or more important, to their maximum interest rate risk (i.e., duration) tolerance – falling prices and higher yields should be welcomed as an opportunity to buy more, not less.

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How much have yields risen?

The simple answer to this question is: a lot, and in a relatively short time. In just the last three months, higher-quality, tax-exempt rates have risen more than 100 basis points (bps) for maturities of 10 years or longer. Not surprisingly, the shortest end of the yield curve has been stickier, since it is anchored by the Federal Reserve's (the Fed) zero interest rate policy.

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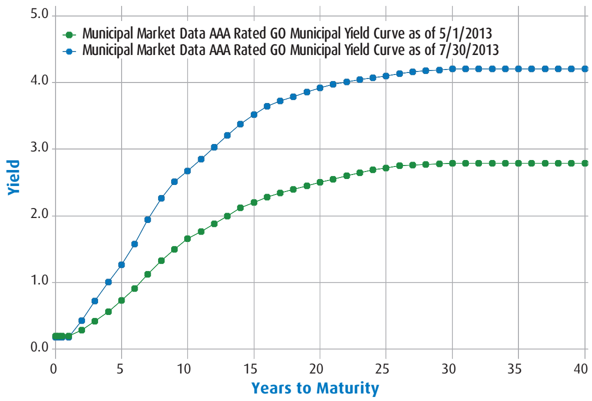
But uncertainty over the potential tapering of the Fed's quantitative easing purchases has created significant anxiety, most acutely felt among intermediate and longer-term bond investors. To make things even more interesting, in the midst of sliding bond prices, Detroit filed for Chapter 9 bankruptcy protection. Although not unexpected, the timing and media attention on the event caught investors a bit off guard. Fund managers were fearful this Detroit filing could accelerate the pace of redemptions, which largely never occurred, but many sold in advance of the potential liquidations.

The sharp steepening of the yield curve has made extending maturities, even modestly, quite rewarding. An investor can pick up 140 bps currently if willing to extend from five years to 10, and a total of 225 bps more to move out to the 15-year maturity range. Aggressive investors who are willing and able to move out into the 20- to 30-year range are now able to capture tax-exempt yields that represent attractive values even if Treasury yields continue to rise. For example, AAA rated, 30-year, tax-exempt yields closed July yielding 115% of the same maturity Treasury bond, a 4.20% municipal yield versus 3.64% for Treasurys. At this relationship, long-term Treasury yields could rise another 56 bps just to get to parity with current tax-exempt yields. Typically, Treasury yields lead the tax-exempt market, but the reverse has been the case recently.

Market commentary *(continued from page 2)*

Even non-tax-paying investors are finding value in the tax-exempt market at current levels. These crossover investors have begun to shift their focus to the municipal market and are able to buy tax-exempts and actually pick up yield relative to comparably rated taxable – a very unusual opportunity.

Moody's cumulative default rates As of 7/31/2013



AAA tax-exempt yields

	2-year	5-year	10-year	15-year	30-year
5/1/2013	0.29%	0.73%	1.66%	2.20%	2.79%
7/31/2013	0.43%	1.27%	2.67%	3.52%	4.20%
Increase	0.14%	0.54%	1.01%	1.32%	1.41%

Source: InvestorTools® Perform

Yields up, new supply down

As tax-exempt yields have risen, the amount of new supply issued has slowed. The amount of new tax-exempt supply has been below 2012 levels for each of the last three months, and year-to-date tax-exempt supply is now down 18% year-over-year. A big part of the reason for this is that as yields have risen, the savings that was once there to refinance outstanding debt has declined or disappeared. Refunding volume is off 22% from last year, and if rates remain elevated or move higher, it will likely decline further as a percentage of total issuance.

The good news for investors, however, is that ample supply and selection remains in the secondary market due to the recent selling pressure. The higher yields and steeper yield curve allow investors to once again construct or add to a portfolio of higher-quality bonds or funds to help meet their income needs. Conservative savers have suffered under the penalty of the aggressive Fed policy. Fed Chairman Bernanke successfully guided and held short- and longer-term market yields at levels that many felt were not rewarding enough to participate or extend into. Now, however, as investors anticipate a modest change in policy from the Fed, the municipal market has run well ahead of the Fed, as investors are prone to do.

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The table below illustrates what various levels of tax-exempt yields, that are now available to investors, equate to on a pre-tax basis for investors in higher income tax brackets. These are yields that are much more in line with the planning many investors and advisors have done as they anticipate income needs in retirement. We hope that those in need of higher income will "ace" this test, by taking advantage of the lower bond prices now provided by the tax-exempt market. ◀

Attractive pre-tax yields

Tax-Free Yield	Federal Income Tax Brackets		
	28.0%	39.6%	43.4%
3.0%	4.2%	5.0%	5.3%
3.5%	4.9%	5.8%	6.2%
4.0%	5.6%	6.6%	7.1%
4.5%	6.3%	7.5%	8.0%

Source: BMO Global Asset Management

Credit updates

Detroit – we're watching!

The City of Detroit filed for protection under Chapter 9 of the federal bankruptcy code on July 18. It is the largest municipal bankruptcy in history by a wide margin. In the filing, Detroit listed a total of $18.1B in liabilities and the next largest municipal bankruptcy was Jefferson County, AL in 2011 with $4.2B in debt. Of the $18.1B in stated liabilities, $6.7B are listed as "secured" claims, primarily consisting of the water and sewer revenue bonds – which importantly is BMO's only exposure to Detroit and our clients' only exposure within BMO investments.

> The Emergency Manager is attempting to treat all general obligation debt

Over 90% of this water and sewer debt owned across the BMO portfolios is also insured. We are highly confident of repayment, but will be tracking developments very closely.

Detroit also lists $11.4B in "unsecured" claims. Lumped together in this category are $2.0B of general obligation debt and $9.2B of retiree benefits. The Emergency Manager is attempting to treat all general obligation debt equally, including voter-approved, tax-backed debt as well as moral obligations of the general fund. We are skeptical that this will withstand the bankruptcy process, but it is still very early in the process. As for the retiree claims, they include $3.4B in unfunded pension liabilities and $5.7B in other post-employment benefits (OPEB), both higher figures than had been previously reported, raising questions as to the methodology of the calculation. Not surprisingly, the size and complexities involved with these claims are what make this filing so interesting and important for all investors to follow.

In a Special Comment published by Moody's on July 26, they very nicely summarized the two main issues that will need to be resolved in this bankruptcy:

1) **The relative seniority of pension liabilities and general obligation bond debt**. Most states have left unclear in state law which creditor class takes primacy over the other when resources are too scarce to satisfy both. Detroit's proceedings may set a precedent for other issuers seeking to expunge one liability or the other.
2) **Whether general obligation bonds are "secured" or unsecured**." The legal distinction is vital. An unsecured creditor class can be placed into a pool with other types of unsecured creditors, such as vendors or leaseholders. If Detroit's state-appointed emergency manager's proposal to treat GO bondholders as unsecured is successful, the example could weaken GO claims relative to secured liabilities in other potential bankruptcy situations.

The answers to these issues may influence the municipal bond market's expectations for pension and debt recoveries, even if they don't set direct legal precedent outside of Michigan.

This bankruptcy process is just beginning and despite Emergency Manager Kevyn Orr's, desire to put this on a fast track, many expect it to take two years or more to resolve all the issues. While this bankruptcy was inevitable, many of the actions Mr. Orr and others have taken seem intended to elevate this to a national stage, and it's worked. The non-municipal experts, such as Meredith Whitney and others, have resurfaced with their pessimistic views on the municipal market – and state and local government affairs in general.

> Missed perhaps amid all the focus on Detroit recently was the improving news for state and local governments.

Missed perhaps amid all the focus on Detroit recently was the improving news for state and local governments. First quarter of 2013 tax revenues for state and local governments, as compared to first quarter of 2012, increased 6.8%, marking the fourteenth consecutive quarter of positive year-over-year growth," according to a U.S. Census Bureau release on June 25. In separate news, several states, particularly some in the Midwest region, are expected to begin the new fiscal year with record reserve funds; Wisconsin, Ohio, Nebraska, and North Dakota among them. And cities and local municipalities are hiring once again. The number of state and local government workers, which make up 65% of all government workers, has grown in seven of the last eight monthly reports, bringing the year-to-date total for 2012 to 46,000 new jobs through June. It will be easy for many to miss the favorable credit backdrop in the municipal market amid all of the negative news surrounding Detroit, but the macro view continues to improve from where we sit. ◂

Performance and strategy

Fund performance as of July 31, 2013

Fund / *Index*	Share class	Inception date	Ticker	As of July 31, 2013 (%) 1-month	YTD	Returns as of July 31, 2013 (%) 1-year	3-year	5-year	10-year	Since inc.	Expense ratios (%)[1] Gross	Net
BMO Ultra Short Tax-Free Fund	I	09/30/09	MUISX	0.07	0.25	0.63	1.34	N/A	N/A	1.52	0.38	0.31
BMO Ultra Short Tax-Free Fund	Y	09/30/09	MUYSX	-0.05	0.11	0.38	1.09	N/A	N/A	1.27	0.63	0.56
Blended Benchmark[2]				*0.05*	*0.21*	*0.32*	*0.48*	*N/A*	*N/A*			
BMO Short Tax-Free Fund[3]	I	11/29/12	MTFIX	0.02	0.09	N/A	N/A	N/A	N/A	0.83	0.78	0.40
BMO Short Tax-Free Fund[3]	Y	11/29/12	MTFYX	-0.10	-0.10	N/A	N/A	N/A	N/A	0.63	1.03	0.55
Barclays Short (1-5 Year) Municipal Index				*0.34*	*0.28*	*N/A*	*N/A*	*N/A*	*N/A*			
BMO Intermediate Tax-Free Fund[4]	I	12/27/10	MIITX	-0.68	-2.88	-1.41	3.84	5.30	4.41	4.58	0.45	0.45
BMO Intermediate Tax-Free Fund	Y	02/02/94	MITFX	-0.61	-2.91	-1.61	3.77	5.26	4.39	4.57	0.70	0.55
Barclays U.S. 1-15 Year Blend Municipal Bond Index				*-0.20*	*-2.15*	*-1.14*	*3.29*	*4.72*	*4.40*			

Other Benchmarks as of July 31, 2013

	As of July 31, 2013 (%) 1-month	YTD	Returns as of July 31, 2013 (%) 1-year	3-year	5-year	10-year
Barclays U.S. 1-10 Year Blend Municipal Bond Index	*0.11*	*-1.23*	*-0.46*	*2.97*	*4.41*	*4.13*
Barclays U.S. Municipal Bond Index	*-0.88*	*-3.54*	*-2.19*	*3.73*	*5.07*	*4.71*

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. 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

The back-up in yields has been significant and swift, particularly among longer maturities. Where appropriate, we are extending along the yield curve to capture the higher yields and steeper slope of the curve. Our focus is on higher-quality issues to do so, both for liquidity purposes and for price performance. Amid intermediate and longer-term strategies, an above-benchmark duration weighting is now appropriate on a tactical basis, but neutral-to-short remains prudent for short-term strategies. We continue to prefer revenue-backed sectors of the market over general obligations. Security structure should emphasize sufficient coupon protection against rates moving even higher.

Strategy overview

Duration: Long for intermediate and long-term strategies; neutral-to-short for short-term strategies

Curve: Where appropriate, lengthen maturities to capture the curve's steepness

Credit: Focus on higher credit quality, AA- or higher, for enhanced liquidity

Sector: Maintain a revenue sector bias, but selectively add general obligation exposure

Structure: Coupon and call structures that offer enhanced return opportunities

Data for the journey

Valuation data as of July 31, 2013

AAA yields

		Change		
Year	Current	*1-month*	*3-month*	*1-year*
2	0.43%	*-0.07%*	*0.14%*	*0.14%*
5	1.27%	*-0.13%*	*0.53%*	*0.62%*
10	2.67%	*0.11%*	*0.98%*	*1.01%*
30	4.20%	*0.37%*	*1.36%*	*1.36%*

Source: InvestorTools® Perform

Cross-market values

	Current (1-Year Averages)	
Year	Muni/Treasury	Muni/Corporate
2	138% (121%)	95% (86%)
5	92% (100%)	78% (76%)
10	104% (99%)	89% (83%)
30	116% (99%)	102% (86%)

Source: InvestorTools® Perform and Bloomberg

Yield curve data as of July 31, 2013

Slope changes

		Change		
	Current	*1-month*	*3-month*	*1-year*
Wkly–2's	0.25%	*0.00%*	*0.16%*	*0.09%*
2–5's	0.96%	*-0.13%*	*0.53%*	*0.62%*
2–10's	2.24%	*0.18%*	*0.84%*	*0.87%*
2–30's	3.77%	*0.44%*	*1.22%*	*1.22%*

Source: InvestorTools® Perform

Performance by duration

Year	*1-month*	*3-month*	*1-year*
0–3	*-0.07%*	*-0.88%*	*0.70%*
3–6	*-0.53%*	*-4.22%*	*-1.25%*
6–10	*-1.35%*	*-7.77%*	*-4.84%*
10+	*-4.11%*	*-14.84%*	*-11.12%*

Source: Barclays Point

Credit Data as of July 31, 2013

Current rating spreads

	Current (1-year averages)	
Year	AAA–A	AAA–BBB
2	0.21% (0.24%)	0.76% (0.81%)
5	0.48% (0.49%)	1.26% (1.38%)
10	0.73% (0.70%)	1.37% (1.47%)
30	0.70% (0.70%)	1.13% (1.33%)

Source: InvestorTools® Perform

Performance by quality

Rating	*1-month*	*3-month*	*1-year*
AAA	*-0.44%*	*-3.79%*	*-1.92%*
AA	*-0.75%*	*-4.67%*	*-2.26%*
A	*-1.04%*	*-5.29%*	*-1.86%*
BBB	*-1.78%*	*-6.19%*	*-3.18%*

Source: Barclays Point

BMO Funds Tax-Free Suite

Fund name	Ticker (Class Y/Class I)
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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