Municipal Bonds

FPA Meeting

April 4th, 2013

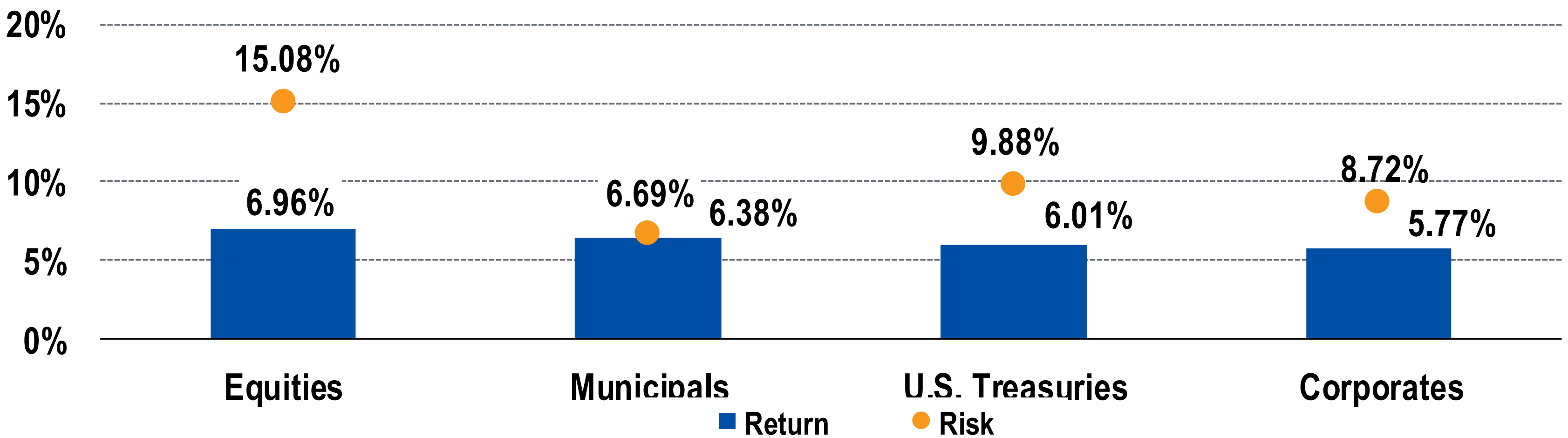
Rafael Costas

Co-Director

Why Municipal Bonds?

Second Best Performing Asset Class, with the Lowest Risk over the 20-Year Period Ended 1/31/13

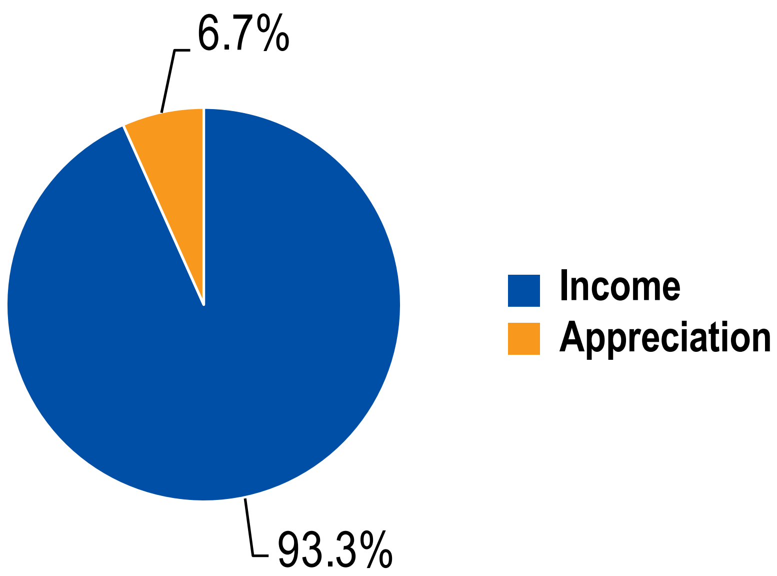
After-Tax Average Annual Total Returns



Source: © 2013 Morningstar (S&P 500 Index, Barclays Long-Term Municipal Bond Index, Barclays Long-Term Treasury Bond Index, and Barclays Long-Term U.S. Credit Index). One cannot invest directly in these unmanaged indices. After-tax returns assume a 20% annual turnover rate transacted monthly. Investment income and capital gains are taxed at marginal historical federal tax rates consistent with those experienced by individuals earning $100,000 annually. Capital losses are carried forward to offset capital gains in future months. For investors subject to federal or state alternative minimum tax, all or a portion of the investment may be subject to such tax, depending on the investment. Distributions of capital gains and of ordinary income accrued from market discounts, if any, are generally taxable. Long-term taxable gains tax effective rates are as follows: 1987-April 1997=28%. May 1997-May 2003=20%. June 2003-January 2013=15%. Volatility, a measure of risk, is determined by the annualized standard deviation of monthly total returns. In general, the higher the standard deviation, the greater the risk. This information is for illustrative purposes only and does not reflect any Franklin Templeton fund performance. This graph is for illustrative purposes only and does not reflect the performance of any Franklin Templeton fund.

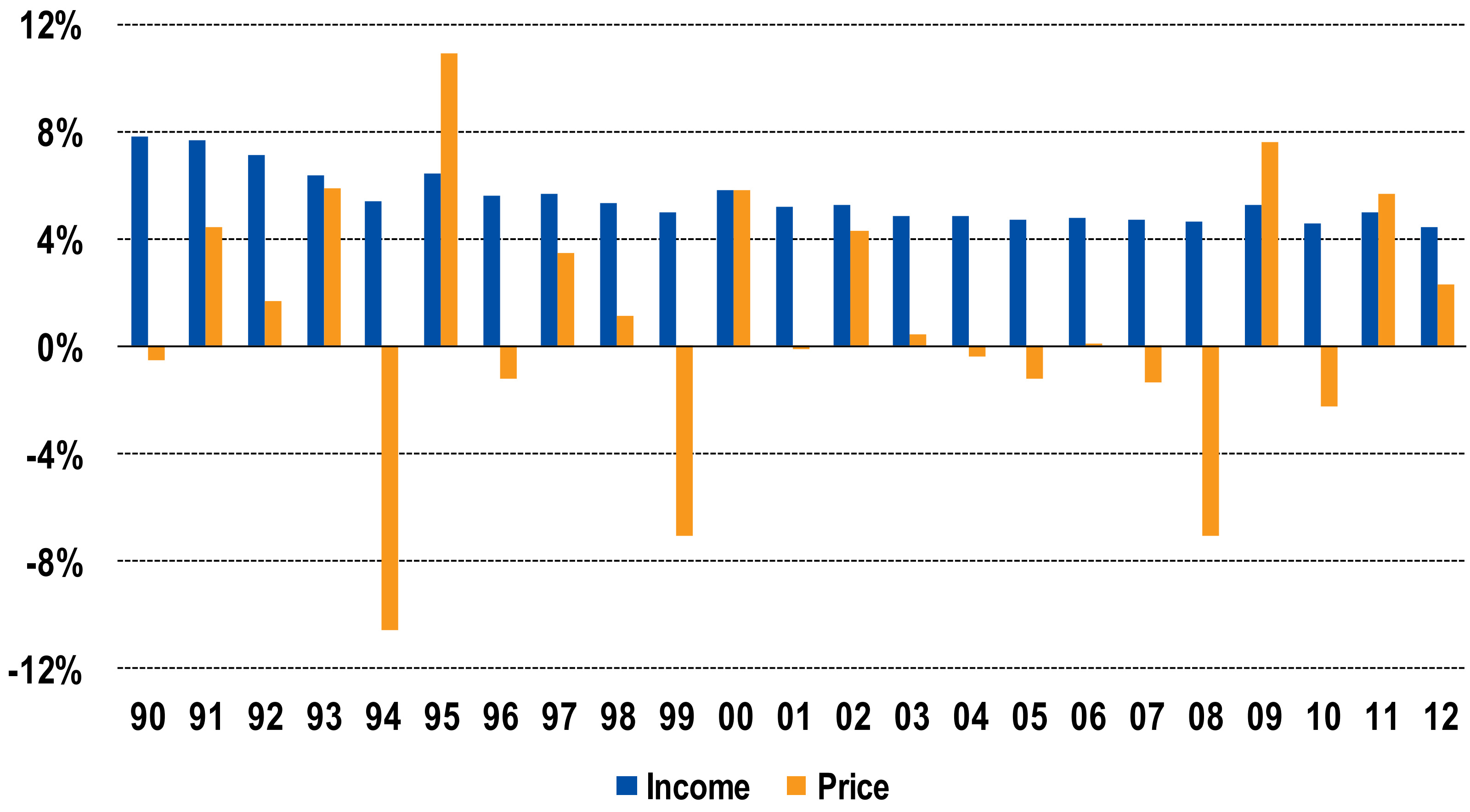
Over the Long-Term, Income Drives Total Return

For the 20-Year Period Ended January 31, 2013



Source: © 2013 Morningstar (Barclays Municipal Bond Index), as of 1/31/13.
Total return includes compounded income and capital appreciation.

Barclays Capital Municipal Bond Index



Source: © 2013 Morningstar, as of 12/31/12. Indices are unmanaged and one cannot invest directly in an index.

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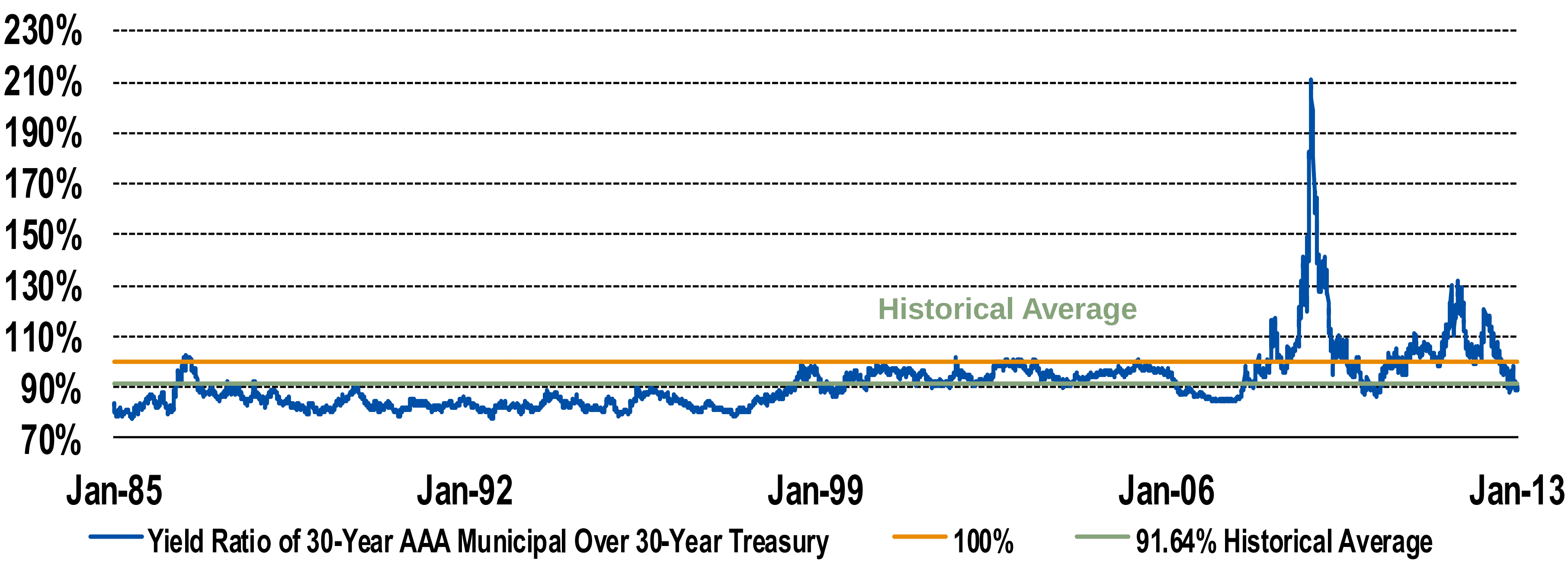
Municipal Bond Valuations

Historical Evolution of the Ratio of 30-Year Municipal to 30-Year Treasury from January 1985–January 2013



Source: Barclays Capital Municipal Index and Strategies Group, Municipal Market Data (a registered trademark of Thomson Reuters), Bloomberg, as of January 31, 2013. 30-year AAA Municipal Bonds represented by 30-year AAA MMD.

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Topics

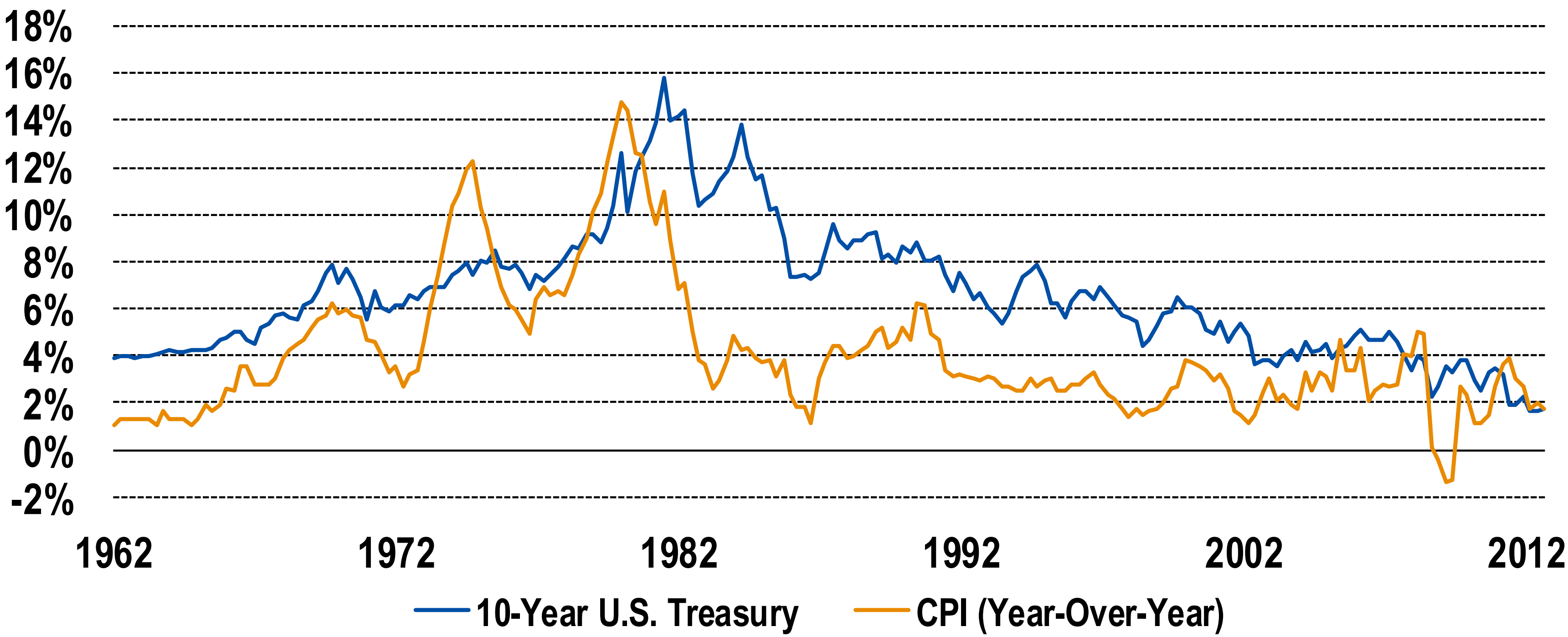
- Interest Rates
- Three Legs of Performance Stool
  - Supply
  - Demand
  - Credit
- Tax Exemption Threat
- Outlook – What to Expect

Interest Rates – Do People Know What They're Asking?

- Which Rates, Long or Short?
- What Affects Long Term Rates Most?
  - Growth
  - Inflation
- How High Do They Go and How Quickly?
- Do They Increase Because of Growth or Before Growth?

Inflation Drives Long-Term Interest Rates

Interest Rates vs. Inflation



Source: Bloomberg, Bureau of Labor Statistics; quarterly data measured through 12/31/12; as of 1/16/13.

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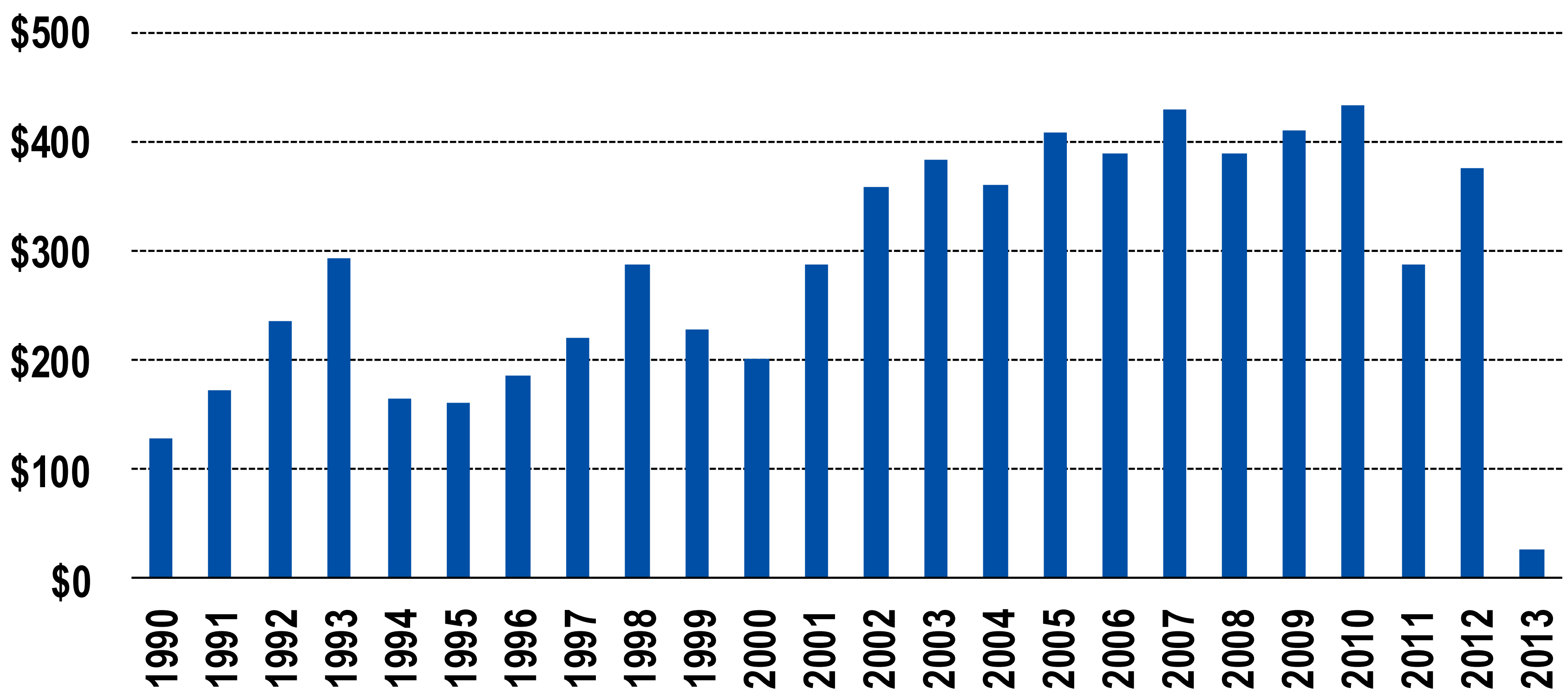
Supply

- **Net New Supply Essentially Zero in 2012**
- **Same Pattern Expected in 2013**
  - Mayors/Governors More Leery of Debt Since 2008 Crisis
  - Upcoming Fiscal Challenges
    - Pensions
    - Decreasing Federal Support

Long-Term Municipal Bond Issuance (in Billions)

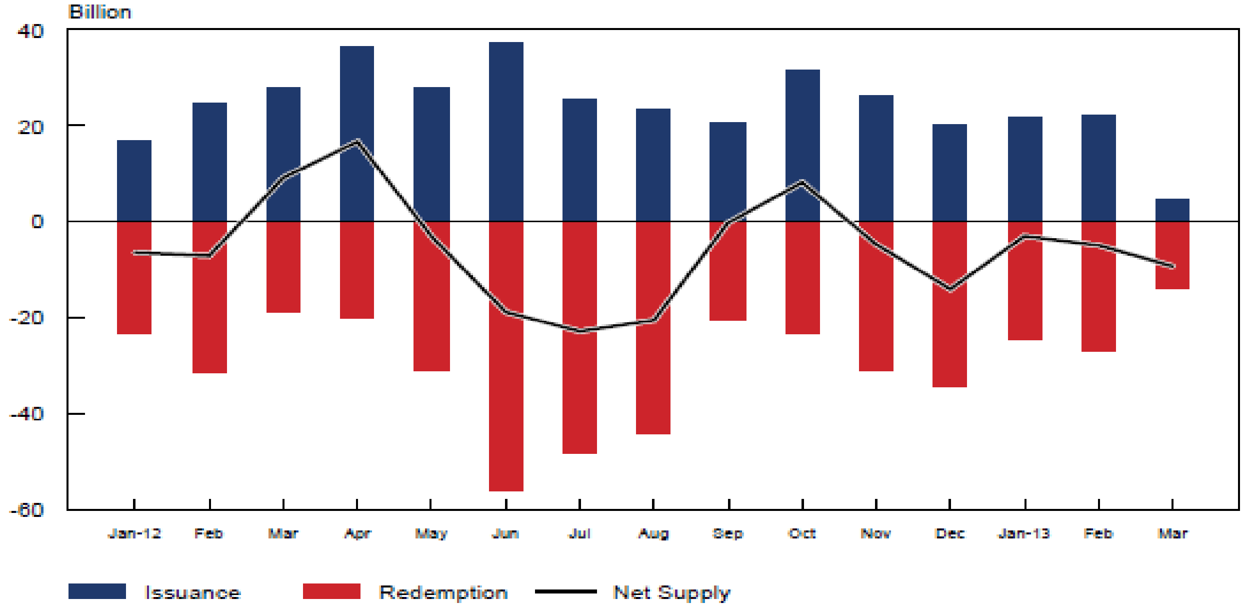
1990–2013



Source: Bond Buyer and © 2013 Thomson Reuters, as of 1/31/13, based on data available on 2/9/13.
Figures are based on issues maturing in 13 months or longer.

Net Supply – Since January 2012

Tax-Exempt Bond Issuance, Redemption, and Net Supply (2012 - 2013 YTD)

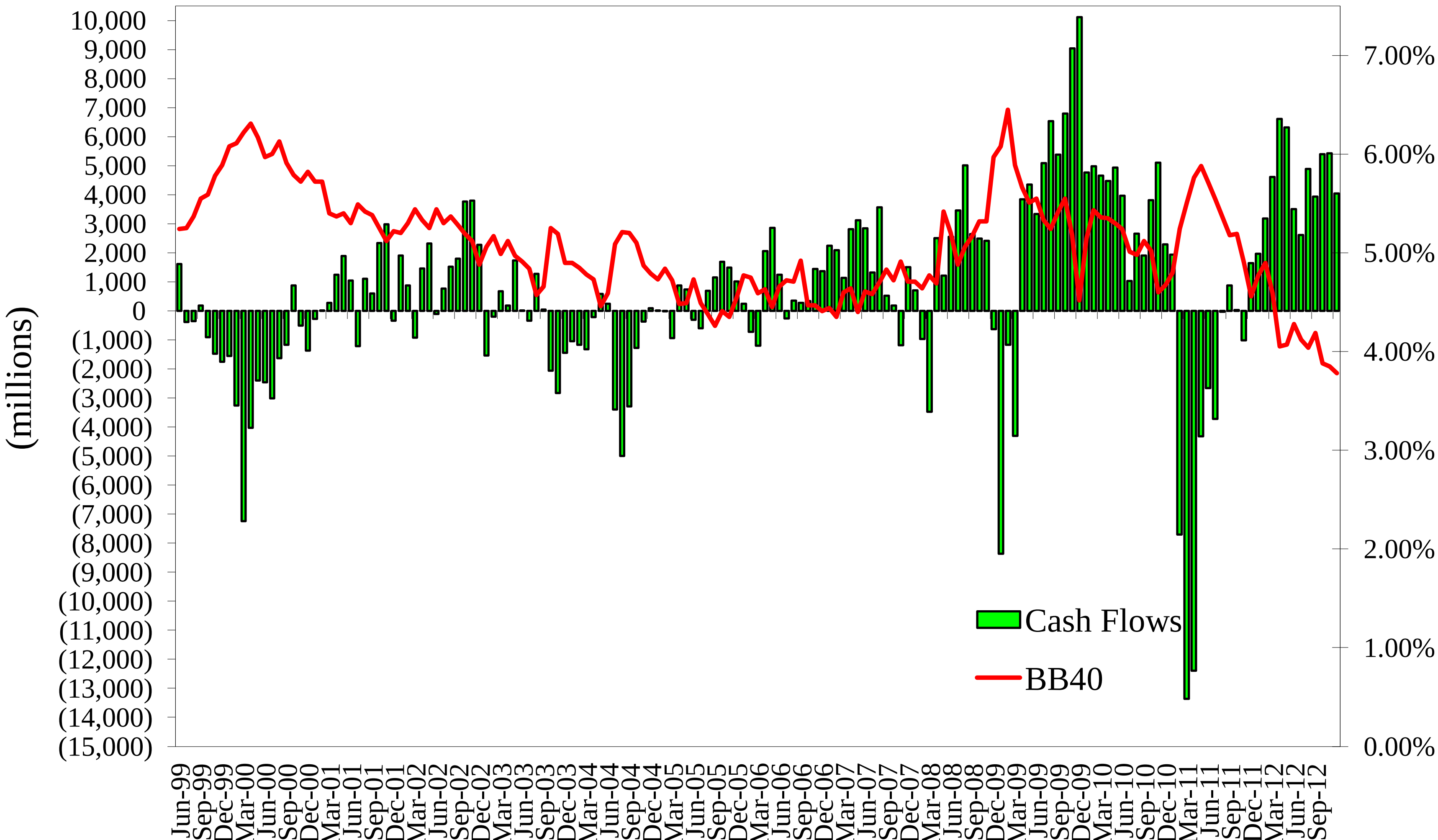


Source: Goldman Sachs

Demand

- **Very Strong from Mid-2011 and 2012**
- **Some Performance Chasing**
- **Low Rates = Low Income**
- **Tax Exemption Concerns?**
- **Great Rotation/Equity Market Performance**
- **Offsets**
  - Diversification is Still Important
  - Income is Still Important
    - More and More Baby Boomers Retiring
  - Higher Income Taxes in U.S. and California

Muni Cash Flows vs. Yield of Bond Buyer 40



Source: ICI/Bloomberg as of 09/30/12

Credit

- **Boy, Was She Off!**
  - Strong Inflows Once Credit Crisis Prediction Busted
- **Economic Activity Picking Up, If Unevenly**
  - Higher Sales/Personal Income Tax Collections
  - Property Taxes Stabilizing
    - Longer to Reflect Improving Housing Markets
  - States/Locals Implemented Austerity…Balanced Budgets
- **Wet Blanket Issues**
  - Pension Obligations and OPEBs
  - Federal Government Outlays
  - Bond Insurance
  - CA Bankruptcies

Tax- Exemption: Benefit to the Wealthy?

- 51% of holdings by individuals <$200k
- 60% of interest goes to investors 65 and older
- Approximately 2/3 of holders are retail investors (funds included)
- Real benefit to residents, users of services and taxpayers
- Issuers more vocal lately

Citigroup, JPMorgan, IRS

Outlook And The Way to Think of Munis

- **Unrealistic to Expect Continued Appreciation**
  - Downside: NAV Losses
  - Upside: Increased Monthly Income
  - Flea-Flicker Market
- **50/50 Odds of Something Happening to Exemption**
- **If Long Term Rates Go Up, Expect Slowly**
- **Focus is on Income and Diversification**