Investment Perspectives

May 2014

Municipal Insights

The BMO tax-free income team

Portfolio managers

John D. Boritzke, CFA

Joseph J. Czechowicz

Craig J. Mauermann

Duane A. McAllister, CFA

Erik R. Schleicher

Credit analysts

A.G. Anglum

Michael E. Janik, CFA

Catherine M. Krawitz, CFA

Andrew W. Tillman

in this issue

Market commentary

Light supply + strong demand = muni rally

The municipal market continued its strong performance trend through April. If you blinked, you may have missed what little selling pressure occurred for tax purposes. A favorable technical backdrop remained the primary driver for last month's strength. Light supply contributed to the favorable performance as April issuance fell 18% from the prior month and year-to-date supply is 29% below 2013 levels. Refunding volume is off due to the rise in rates last year and, despite significant infrastructure needs and attractive borrowing costs, fiscal austerity is preventing many municipalities from taking on new debt. State spending has increased an average of just 0.7% annually since 2007 (although this may be changing – see below), so projects get deferred and muni investors scramble to find enough new bonds.

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The other positive factor has been strong investor demand. Fund flows remain positive and appear likely to remain so. Significantly more money left the market last year than has returned, suggesting that positive flows may continue. Adding to the favorable technical outlook is the expectation for strong reinvestment demand over the summer months. June and July in particular are among the highest months for coupon payments and roll-off from bond calls and maturities, much of which is expected to return to the municipal market.

Flatter and unsustainably still

The tax-exempt yield curve continued its flattening trend. Last month, although all rates fell, intermediate and long rates fell the most; two-year yields declined by 4 basis points (bps), while ten-years and longer dropped at least 16 bps. The year-to-date curve flattening has been impressive, reversing more than one-half of the steepening that occurred in 2013. The 2s – 30s slope of the tax-exempt curve steepened 134 bps last year, but has narrowed 72 bps in 2014.

This unsustainable stability has frustrated those looking for higher, not lower, rates this year

Yet, total market volatility has been muted for the past three months. The Federal Reserve's (Fed's) desire to dampen interest rate volatility through improved market communication appears to have worked recently. For example, the 10-year Treasury yield has traded in a narrow 25 bps band, between approximately 2.60% and 2.85%, since the end of January. This unsustainable stability has frustrated those looking for higher, not lower, rates this year (ourselves included).

We continue to expect a break to higher yield levels at some point this year, as we anticipate better economic data. The economy is not as weak as the preliminary estimate of first quarter gross domestic product (GDP) growth of 0.1% would indicate, but whether or not the expected rebound in the second quarter occurs remains to be seen. Nonetheless, we intend to play a bit more defense than offense across the BMO tax-free strategies in regard to the outlook for rates. And while the intermediate-term outlook is for continued flattening of the curve, near-term a more neutral curve stance seems appropriate, particularly the five- to nine-year maturity range. The benefit of rolling down the steepest segment of the curve may be an investor's best source of excess return for the balance of the year.

You go, GO!

From a sector perspective, we have maintained a bias toward revenue-backed (RV) bonds over general obligation (GO) debt for the last several years. The reasons for this are many, including: 1) a dedicated revenue stream, 2) flexibility to raise rates, 3) moderate pension liability risk and 4) surprisingly, a yield advantage over other sectors. While these strengths largely remain, the landscape for RVs is becoming more balanced relative to GOs. Property tax collections, typically the primary revenue source for local GOs, are rising. The 3% annual gain in 2013 was the largest since 2009, when property tax revenues rose 9% before the lagged impact of falling home prices hit. Now, the reverse is occurring as the benefit from rising home values is boosting revenues. The S&P/Case-Shiller Composite-20 City Home Index, which tracks home prices across the 20 largest metro areas, is up nearly 13% from year-ago levels. Property tax revenues will continue to rise even if the rebound in home prices slows, as many expect.

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State GO strength is also improving. Unlike local property taxes, which act with a lag, state tax revenues benefit from the quicker cyclical rebound in sales, income and corporate tax revenue. The recent tax season should be strong given the significant increase in wealth last year from a rising stock market and improving real estate markets. Yet, even as the state revenue picture improves, economic uncertainty remains evident in the generally conservative budgeting. On average, the nation's governors expected just a 0.8% average increase in revenues for FY2014. And, although spending is projected to rise 3.8% on average, states have been very frugal and are only now beginning to restore some previous spending cuts.

The other boost to the GO sector is ongoing pension reform at both the state and local levels. Reform efforts are a slow and difficult process, subject to ongoing legal and political challenges. Yet, progress is being made on a broad basis. Key constituencies now recognize that if not addressed, rising annual pension and retirement healthcare costs will crowd out funding needs in other essential areas, such as education and public safety. We remain long-term optimists in this area. Therefore, we see better days ahead from a credit perspective for both state and local GOs and intend to gradually increase our allocation to the GO sector across the BMO tax-free strategies.

Speaking of GOs – what's up in Detroit?

Last month, Detroit's Emergency Manager, Kevyn Orr, reached a settlement with the insurers on the unlimited tax GO (UTGO) debt of Detroit. While subject to court approval, the insurers agreed to accept 74% of the $388 million outstanding debt, up from the latest plan of adjustment proposal of 15%. The reason Mr. Orr cited for agreeing to the significantly higher recovery was that the insurers "agreed to give us (Detroit) the equivalent of 26% of what they're owed from a dedicated revenue stream. That's the equivalent of $100 million" to the city. He also admitted that since the tax levy was specifically assessed for repayment of debt, the tax millage "could all go away" if not used for that purpose.

Assuming the court approves the settlement, this should strengthen the argument in favor of UTGO debt holders in future cases. Although this won't establish a legal precedent per se in Michigan or elsewhere, in this large, visible case, the city acknowledged the legal risk (if not the probability) that the court would rule that UTGO bonds have a lien on pledged ad valorem taxes, which constitutes a special revenue in the U.S. bankruptcy code. For the insurers, while taking a modest haircut on the bonds, their flexibility on the UTGO debt may help them in ongoing and future negotiations with the city. Despite the settlement, insured bondholders will receive 100% of their money, as guaranteed by the insurers, reinforcing the view that insurance does have value in periods of fiscal stress or bankruptcy. We can't help but believe Mr. Orr's initial offer of 20%, and then 15%, was simply a negotiation strategy all along in an effort to get some additional revenue for the city. If so, it worked.

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Credit updates

The changing nature of higher education

Higher education in the U.S. is changing rapidly. Change is being driven by a myriad of influences, all of which are forcing colleges, large and small, public and private, to evaluate the most efficient means to deliver the knowledge and skills necessary for the 21st century. Some will successfully adapt and survive, if not thrive, while others won't and will be forced to close.

> More online classes will be offered to a more racially and demographically diverse student body

Harvard Business School Professor Clayton Christensen estimates that as many as one-half of the more than 4,000 universities and colleges in the U.S. may close within fifteen years. Those that survive will certainly look different a decade from now. More online classes will be offered to a more racially and demographically diverse student body. Understanding the forces of change and then identifying the winners and losers are ongoing efforts by the BMO credit team.

The demographic trend is not favorable for higher education, as the number of high school graduates is declining nationally, particularly in the Northeast and Midwest. The National Center for Education Statistics reports that the number of high school graduates peaked in 2008-09 and will decline through 2014-15, not reaching a new peak again until at least 2020-21. As competition stiffens for fewer students, small, private colleges - many with fewer than 1,000 students and little or no endowment, - are most at risk. Almost entirely dependent upon tuition revenue to meet their operating needs, and with growing capital needs, it will become increasingly difficult to compete with their elite, well-endowed competitors.

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Although public universities typically have a competitive cost advantage over private institutions when competing for new students, state funding has fallen, forcing them to raise tuition and cut expenses. During the recent recession, funding to higher education fell an average of 28% and has only recently begun to rebound. The larger, nationally recognized public universities, often with strong alumni support, are likely to fare better than the smaller, less recognized public universities. We expect to see closures or consolidations in the public university sector as well.

Community colleges are likely to play an even more integral part in the future of higher education, particularly given the need for many to find a more affordable education option and for families to achieve a return on their education investment. Already, 21 states allow community colleges the ability to offer a four-year degree and a few, such as Oregon and Tennessee, now offer free tuition. These and other programs increasingly put community colleges in direct competition with public universities, forcing both to adapt and change.

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In conclusion, whether it is technological advances and greater acceptance of online learning, declining enrollment due to demographics, rising costs for ongoing capital needs in the face of a rationalization of funding, or the adaptation of programs to meet today's employment needs, the higher education landscape is changing rapidly. We plan to be on the leading edge of identifying winning institutions for the benefit of our investment clients and shareholders.

Strategy and performance

Strategy

The strong rally through April has pushed rates to a level that warrants a cautious duration stance. While the technical support for the tax-exempt market should be favorable through the summer months, we expect the pace of economic growth to improve and put upward pressure on all market rates. The significant flattening of the yield curve since year-end now favors a more neutral curve stance near-term, with the focus on the intermediate segment of the curve where the roll is most beneficial. We take a more balanced view now regarding GOs relative to revenue bonds, favoring strong and rebounding metro areas. We continue to seek opportunities in credit and security structure where available.

Strategy overview

Duration: Neutral-to-short

Curve: Focus on the steep intermediate segment of the yield curve, particularly the five- to nine-year range, where the benefits of rolling down the curve are most beneficial

Credit: Seek selective opportunities in the A and/or BBB rating category when adequately rewarded through additional yield

Sector: Take a more balanced view between the revenue and general obligation sectors of the market; focus GO purchases in strong or cyclically rebounding metro areas

Structure: Premium coupon structure to minimize market discount risk

Fund performance as of April 30, 2014

				As of April 30, 2014 (%)		Returns as of April 30, 2014 (%)					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	Y	09/30/09	MUYSX	0.05	0.39	0.55	1.03	—	—	1.23	0.58	0.56
BMO Ultra Short Tax-Free Fund	I	09/30/09	MUISX	0.07	0.48	0.70	1.28	—	—	1.46	0.33	0.31
Blended Benchmark [2]				*0.03*	*0.15*	*0.39*	*0.47*	—	—			
BMO Short Tax-Free Fund [3]	Y	11/29/12	MTFYX	0.51	1.42	1.10	—	—	—	2.29	1.07	0.56
BMO Short Tax-Free Fund [3]	I	11/29/12	MTFIX	0.52	1.47	1.25	—	—	—	2.44	0.82	0.41
Barclays Short (1-5 Year) Municipal Index				*0.25*	*0.63*	*1.03*	—	—	—			
BMO Intermediate Tax-Free Fund [4]	Y	02/02/94	MITFX	1.12	3.56	0.42	5.11	5.41	4.59	4.65	0.62	0.56
BMO Intermediate Tax-Free Fund	I	12/27/10	MIITX	1.14	3.63	0.61	5.23	5.48	4.62	4.66	0.37	0.37
Barclays U.S. 1-15 Year Blend Municipal Bond Index				*1.00*	*3.29*	*0.95*	*4.43*	*4.56*	*4.48*			

Other benchmarks as of April 30, 2014

	As of April 30, 2014 (%)		Returns as of April 30, 2014 (%)			
	1-month	YTD	1-year	3-year	5-year	10-year
Barclays U.S. 1-10 Year Blend Municipal Bond Index	*0.84*	*2.46*	*0.93*	*3.73*	*3.98*	*4.16*
Barclays U.S. Municipal Bond Index	*1.20*	*4.56*	*0.50*	*5.59*	*5.54*	*4.83*

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 quoted are pre-tax. Investor should consider his or her current and anticipated investment horizon and income tax bracket when making an investment decision as the illustration above does not reflect these factors. For more information about performance, please contact your investment professional. Total returns for periods of less than one year are cumulative.

1 Net expense ratios reflect contractual fee waivers and/or expense reimbursements if applicable, 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, 2014 without the consent of the Board of Directors, unless the investment advisory agreement is terminated. Without these contractual waivers, the Fund's returns would have been lower.

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.

Data for the journey

Valuation data as of April 30, 2014

AAA yields (%)				
		Change		
Year	Current	*1-month*	*3-month*	*1-year*
2	0.35	*-0.04*	*0.05*	*0.06*
5	1.23	*-0.08*	*0.13*	*0.49*
10	2.30	*-0.19*	*-0.23*	*0.61*
30	3.49	*-0.16*	*-0.36*	*0.65*

Source: InvestorTools® Perform

Cross-market values (%)		
	Current (1-year averages)	
Year	Muni/Treasury	Muni/Corporate
2	85 (113)	64 (75)
5	73 (93)	77 (74)
10	87 (101)	84 (86)
30	101 (109)	94 (97)

Source: InvestorTools® Perform and Bloomberg

Yield curve data as of April 30, 2014

Slope changes (%)				
		Change		
	Current	*1-month*	*3-month*	*1-year*
Wkly - 2's	0.29	*-0.06*	*-0.08*	*0.10*
2 - 5's	0.82	*-0.08*	*0.13*	*0.49*
2 - 10's	1.95	*-0.15*	*-0.28*	*0.55*
2 - 30's	3.14	*-0.12*	*-0.41*	*0.59*

Source: InvestorTools® Perform

Performance by duration (%)			
Year	*1-month*	*3-month*	*1-year*
0–3	*0.52*	*1.07*	*1.45*
3–6	*1.17*	*2.20*	*0.39*
6–10	*1.74*	*3.65*	*-1.70*
10+	*2.48*	*7.07*	*3.55*

Source: Barclays Point

Credit data as of April 30, 2014

Current rating spreads (%)		
	Current (1-year averages)	
Year	AAA–A	AAA–BBB
2	0.16 (0.18)	0.65 (0.71)
5	0.43 (0.47)	1.00 (1.17)
10	0.67 (0.75)	1.30 (1.42)
30	0.70 (0.75)	1.22 (1.26)

Source: InvestorTools® Perform

Performance by quality (%)			
Rating	*1-month*	*3-month*	*1-year*
AAA	*1.05*	*1.77*	*0.60*
AA	*1.16*	*2.27*	*0.74*
A	*1.27*	*2.87*	*0.86*
BBB	*1.56*	*5.33*	*-3.82*

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

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

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.

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Keep in mind that as interest rates rise, prices for bonds with fixed interest rates may fall. This may have an adverse effect on a 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.

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 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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BMO Global Asset Management

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