

Municipal Insights

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Market Commentary

Armageddon Must Wait

Pundits have been warning fixed income investors for years about the inevitable rise in interest rates and the pain and suffering it may cause to their portfolios. The latest to join this chorus was Securities and Exchange Commission (SEC) member Dan Gallagher at a recent SEC-sponsored fixed income round-table discussion. Referring to both the interest rate and credit risk of the municipal market he said, "We've got Armageddon on our hands." Unapologetic, in a follow-up interview he said, "I made the comment in the context of credit risk plus interest rate risk being two major factors that maybe investors don't fully understand." Driving the SEC's concern for the municipal market is the dominance of the retail investor, who make up roughly two-thirds of the municipal market. Expect to hear more warnings of pending doom for fixed income investors the longer interest rates stay low. However, investors have been warned for years now of both risks – rising interest rates and higher municipal defaults – yet neither have occurred.

In fact, last month interest rates fell in response to weaker economic data. Starting with the disappointing employment report with just 88,000 new jobs in March, which triggered broader concerns over another "spring swoon," investors pushed yields lower across the curve. Short-term rates were little changed, but the yield curve flattened as the spread between 2's – 10's narrowed by 20 basis points (bps). Surprisingly, tax-exempt yields outpaced falling Treasury yields despite persistent outflows from tax-exempt funds, in part to meet the April 15 tax deadline, and rising new supply.

Eventually, the chorus of pundits predicting higher interest rates will be right, we hope. While we do not wish the pain and suffering that Armageddon connotes on any investor, and we intend to take every step possible to minimize the impact of rising

rates on BMO clients and fund shareholders, we long for the days in which conservative investors can once again earn a reasonable risk-, tax-, and inflation-adjusted return on their money. That is simply not the case currently. The Fed and other global central banks continue their extraordinary monetary easing to boost growth; the latest example being the Bank of Japan. In the meantime, investors who tier their cash and fixed income holdings to capture roll-down opportunities from an upwardly sloping yield curve and who prudently accept and manage credit risk should be rewarded.

Surprisingly, tax-exempt yields outpaced falling Treasury yields despite persistent outflows from tax-exempt funds

Just as Meredith Whitney's municipal default predictions in December 2010 were wildly exaggerated, we believe Dan Gallagher's alarming rhetoric will also prove to be far from the mark. While the handful of investment grade municipalities that have filed Chapter 9 bankruptcy or defaulted over the last couple of years are well known (e.g. Stockton, San Bernardino, Harrisburg, Jefferson Co., etc.), less appreciated are the vast number of municipalities that are healing, with rising revenues and growing reserve funds. The broad improvement in the fiscal condition of municipalities is reflected in the significant narrowing of credit spreads that has occurred since the post-Whitney peak. Yet, we still find value in select credit categories. Ten-year tax-exempt A and BBB rated debt, for example, provides an average additional yield of 65 bps and 132 bps, respectively, over similar maturity AAA rated debt. Given the extremely low historic default rate for traditional municipal debt and a gradually improving economy, it appears Armageddon will just have to wait awhile longer.

Market Commentary (continued from page 2)

Pension Problems and Progress

There are some, however, who believe that Armageddon lies in the long-term pension challenges municipalities face. Admittedly, the numbers can be staggeringly large. Official estimates put the collective unfunded pension liability for state and local governments, under current actuarial assumptions, at

Policy makers now largely realize that, left unchecked, future pension contributions could climb significantly

approximately \$1 trillion. But this estimate relies on rather optimistic return assumptions. For example, last year the California Public Employees' Retirement System (CalPERS) lowered their annual return assumption from 7.75% to 7.50%, still perceived by many to be too high. Illinois public pension funds assume an average return above 8.0%. Using very conservative assumptions some have estimated the future public pension liability to be as much as \$4 trillion, equivalent to the entire outstanding municipal market debt.

The rating agencies are changing their methodology to more fully consider future pension liabilities. Last month, Moody's placed 29 local governments and school districts on negative outlook based on its new approach to analyzing public pension liabilities. The greatest concentration of municipalities on the list was in Ohio, but several Illinois cities were noted, including Chicago. Policy makers now largely realize that, left unchecked, future pension contributions could climb significantly, consuming a growing percentage of revenues and crowding out other important services.

The good news is that municipalities are slowly, but steadily, addressing the liability gap through varying

levels of pension reform. For example, Kentucky recently approved a new hybrid pension system in which all new employees will have a 401(k)-type plan, joining Utah, Alaska and Illinois which have made similar reforms. Several states are modifying their pension cost-of-living-adjustments (COLAs). Colorado, Minnesota, South Dakota, and New Jersey have already reduced their COLA formula, and in Kentucky, COLAs will only occur if the general assembly has pre-funded them. This form of "conditional indexing" has helped Wisconsin's pension system remain fully funded as the annuity income stream that retirees receive varies based on investment returns. Even Puerto Rico, the poster-state for underfunded pension liabilities, passed meaningful pension reform last month. With it, the retirement age was raised for some public workers, worker contributions were increased and monthly income benefits were lowered, among other reform measures.

The bottom line is that while the long-term liabilities many municipalities face are real, and significant, important steps are being made today to address these challenges. The deep recession and financial crisis was a reality check for municipalities and brought to the light of day these long-hidden liabilities. This is a long road and many more difficult choices remain for taxpayers, current and future retirees, and policy makers. Thankfully, however, the third rail of pension reform is no longer off limits; an encouraging and refreshing sign for municipal credits. ◀

Credit Updates

The State of the States

State governments have recovered financially from the deep recession and are now focused on economic development (e.g., jobs). Economic development takes many forms, but is the key factor in the ongoing recovery of state and local governments. Financial incentives for start-up firms and those that relocate to the state are traditional means of promoting growth, but tax policy is increasingly important. More than a dozen states are currently considering major tax overhauls to help create jobs.

Economic development also involves a focus on the fiscal strength of the local municipalities. While many states have historically monitored the financial strength of school districts and local governments, a more formalized and transparent process is unfolding, differing state by state. New York, for example, recently announced a formalized process for reviewing local governments, but Albany cannot intervene directly in a local government's operations. In contrast, the Local Government Commission of North Carolina must not only approve all local debt issuance, but it also has the power to take over a local government's financial operations, if deemed necessary.

State oversight and intervention has a track record of success, even in some of the more fiscally challenged states. Despite the well-publicized fiscal challenges for

the State of Illinois, the State Board of Education annually provides a very helpful financial profile on each school district, offering the public and investors a perspective on a school district's relative financial strength. Moody's

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acknowledges that while the State of Illinois is the lowest rated of all states, at A2, it has the highest percentage of AAA and AA rated school districts of any state.

Another benefit to municipal investors is state credit enhancement programs. Over 20 states currently provide a credit enhancement program for school districts that issue debt. Some of the programs have direct state support (Michigan) or provide an intercept mechanism for state aid (Indiana). The State of Michigan is viewed as having one of the strongest school district enhancement programs. These programs offer districts lower borrowing costs which benefits the local communities. In sum, the coordination between state and local municipalities is rewarding to both parties and a refreshing sign for municipal credits. ◀

Performance and Strategy

Fund Performance as of April 30, 2013

Fund / Index	Share Class	Inception Date	Ticker	As of April 30, 2013 (%)		Returns as of April 30, 2013 (%)					Expense Ratios (%) ¹	
				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	0.18	0.42	1.30	1.60	N/A	N/A	1.68	0.38	0.31
BMO Ultra Short Tax-Free Fund	Y	09/30/09	MUYSX	0.06	0.34	0.95	1.34	N/A	N/A	1.42	0.63	0.56
<i>Blended Benchmark</i>				<i>0.03</i>	<i>0.17</i>	<i>0.39</i>	<i>0.57</i>	<i>1.15</i>	<i>1.69</i>			
BMO Short Tax-Free Fund ²	I	11/29/12	MTFIX	0.51	1.44	N/A	N/A	N/A	N/A	2.19	0.78	0.40
BMO Short Tax-Free Fund ²	Y	11/29/12	MTFYX	0.50	1.39	N/A	N/A	N/A	N/A	2.13	1.03	0.55
<i>Barclays Short (1-5 Year) Municipal Index</i>				<i>0.18</i>	<i>0.74</i>	<i>1.55</i>	<i>2.33</i>	<i>3.33</i>	<i>3.10</i>			
BMO Intermediate Tax-Free Fund ³	I	12/27/10	MIITX	0.94	1.44	5.31	6.10	6.37	4.73	4.88	0.45	0.45
BMO Intermediate Tax-Free Fund	Y	02/02/94	MITFX	1.01	1.47	5.12	6.04	6.34	4.71	4.87	0.70	0.55
<i>Barclays U.S. 1-15 Year Blend Municipal Bond Index</i>				<i>0.89</i>	<i>1.24</i>	<i>4.02</i>	<i>5.25</i>	<i>5.53</i>	<i>4.62</i>			

Other Benchmarks as of April 30, 2013

	As of April 30, 2013 (%)		Returns as of April 30, 2013 (%)			
	1 Month	YTD	1 Year	3 Year	5 year	10 Year
<i>Barclays U.S. 1-10 Year Blend Municipal Bond Index</i>	<i>0.70</i>	<i>1.19</i>	<i>3.28</i>	<i>4.59</i>	<i>5.04</i>	<i>4.26</i>
<i>Barclays U.S. Municipal Bond Index</i>	<i>1.10</i>	<i>1.39</i>	<i>5.19</i>	<i>6.18</i>	<i>6.09</i>	<i>5.05</i>

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

³ 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 solid performance of the municipal market in April, despite challenging technical conditions, suggests the recent relative strength may continue. We expect that cash outflows from tax-exempt funds should slow and turn positive once again. The yield curve remains steep, cash rates are low, and there is a nearly insatiable demand for income from investors – all positive signals for the market. In addition, reinvestment demand should improve over the summer months as coupon payments and bond calls are scheduled to rise. Offsetting these positive factors, however, is the low nominal yield levels and the relatively limited protection they provide against rising rates. Caution remains the dominant theme, but we are constructive on the market in the near term.

We continue to like the roll opportunities among intermediate maturities, optimized in the 8 – 13 year segment of the yield curve. Revenue bonds are preferred over general obligations, given the ongoing ratings and pension pressures on local municipalities, in spite of an improving economy. We are overweight healthcare as balance sheets and operating margins are strong across most systems. Our preferred security structure is “cushion” bonds where the call option is well in-the-money, providing significant premium protection against higher interest rates.

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 April 30, 2013

Year	AAA Yields			
	Current	Change		
		1 Mo	3 Mo	1 Yr
2	0.29%	-0.02%	-0.05%	-0.02%
5	0.74%	-0.10%	-0.05%	-0.08%
10	1.69%	-0.22%	-0.13%	-0.18%
30	2.84%	-0.25%	-0.02%	-0.41%

Source: InvestorTools® Perform

Year	Cross-Market Values	
	Current (1-Year Averages)	
	Muni/Treasury	Muni/Corporate
2	139% (120%)	87% (81%)
5	109% (102%)	78% (73%)
10	101% (102%)	82% (81%)
30	99% (101%)	86% (85%)

Source: InvestorTools® Perform and Bloomberg

Yield Curve Data as of April 30, 2013

	Slope Changes			
	Current	Change		
		1 Mo	3 Mo	1 Yr
Wkly-2's	-0.01%	-0.10%	-0.12%	0.03%
2-5's	0.53%	-0.10%	-0.05%	-0.08%
2-10's	1.40%	-0.20%	-0.08%	-0.16%
2-30's	2.55%	-0.23%	0.03%	-0.39%

Source: InvestorTools® Perform

Year	Performance By Duration		
	1 Mo	3 Mo	1 Yr
0-3	0.29%	0.58%	2.46%
3-6	0.99%	1.12%	5.47%
6-10	1.73%	1.06%	6.56%
10+	3.07%	0.89%	10.93%

Source: Barclays Point

Credit Data as of April 30, 2013

Year	Current Rating Spreads	
	Current (1-Year Averages)	
	AAA-A	AAA-BBB
2	0.22% (0.27%)	0.77% (0.90%)
5	0.44% (0.54%)	1.24% (1.50%)
10	0.65% (0.71%)	1.31% (1.61%)
30	0.70% (0.70%)	1.24% (1.43%)

Source: InvestorTools® Perform

Rating	Performance By Quality		
	1 Mo	3 Mo	1 Yr
AAA	0.91%	0.81%	3.68%
AA	1.07%	0.93%	4.81%
A	1.24%	1.17%	6.38%
BBB	0.98%	0.65%	6.18%

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.

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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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