Investment Perspectives
July 2013

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

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Market Commentary

Volatility Returns

Although the Federal Reserve's (Fed) dual mandate is to focus on employment and inflation, a real-time gauge of the success or failure can be determined by the level of volatility in the financial markets. Markets do not like surprises and react quickly when caught off guard. Fed Chairman Ben Bernanke was reminded of this once again last month as his attempt to articulate and clarify the current Federal Open Market Committee's (FOMC) thinking may have created greater uncertainty instead. Unfortunately, the heightened volatility was costly for investors, particularly those who held long-duration assets.

> Markets do not like surprises and react quickly when caught off guard.

The volatility officially began on May 22, during Bernanke's testimony before the Joint Economic Committee of Congress. When asked about tapering the Fed's monthly asset purchases, he responded that they "could in the next few meetings … take a step down in our pace of purchases." Surprised by this, the market began to push bond yields marginally higher. But it was Bernanke's post-FOMC meeting press conference on June 19 that pushed yields sharply higher. Rather than back away from his earlier comment, he outlined a scenario in which the Fed could begin to reduce the pace of purchases before year-end, stopping completely by mid-2014. The markets took this to be a more significant change in Fed policy than what Bernanke seemed to intend. Investors ran for the exits, which were too narrow to handle the rush. Dealers were unable to meet the secondary market selling demand; volatility rose and liquidity fell as a result. A record $80 billion was redeemed from U.S. bond funds and exchanged traded funds (ETFs) in June, nearly double the previous record of $41.8 billion set in October 2008 following the Lehman bankruptcy.

Municipal funds were at the center of the heat. $4.5 billion left muni bond funds in one week, eclipsing the previous $4 billion weekly record set in January 2011 at the height of the Meredith Whitney sell-off. The technical pain in the municipal market was felt most acutely among long-term and high-yield funds, which steepened the yield curve and widened credit spreads.

> When Fed Chairman Bernanke's term ends in January he may be more than ready to step back from the volatility.

The daily yield adjustments for AAA yields were reminiscent of the most volatile periods of both 2008 and 2011, moving as much as 20 basis points (bps) per day for several days across intermediate and longer maturities. Longer duration generally underperformed relative to shorter duration in June as the curve steepened.

Other Fed governors spoke or posted comments in the days following Bernanke's press conference to help calm the markets. Their collective message was that the market had gotten it wrong or overreacted to the Chairman's message. Maybe, but the damage was done. This is what can happen when monetary policy is extended – and in unprecedented territory as well. This is not the first, nor the last, time that the Fed and the markets will miscommunicate. When Fed Chairman Bernanke's term ends in January he may be more than ready to step back from the volatility.

Illinois or Greece?

The sharp rise in municipal yields did create attractive valuations for the opportunistic investor. The hallowed 5.0% tax-exempt yield in longer-term, higher-quality bonds that had been missing for nearly two years returned. Crossover investors, who normally focus on the taxable market, were among the first to capture the relative value in longer maturity tax-exempts. The

Market Commentary *(continued from page 2)*

bellwether issue that would price at the peak market yields was the $1.3 billion State of Illinois general obligation (GO) deal. Illinois is the lowest rated among all state GOs (A3/A-/A-, with a negative outlook from all three rating agencies). It has approximately a $6 billion backlog of unpaid bills and, so far, has been unable to reach a political compromise for its unfunded pension and retirement liabilities. Yet, despite concerns by some investors over this credit, the state was determined to issue the loan even in the midst of the turmoil. For investors, the Illinois loan was either going to highlight the illiquidity of the municipal market, or, if successfully placed, demonstrate that sufficient demand existed at the new, higher yield levels. The latter view prevailed as there was $9 billion in orders for the $1.3 billion issue. The longest maturity, in 2038, was priced to yield 5.65%, a very compelling yield for risk tolerant investors in the higher income tax brackets. A 5.65% tax-free yield is equivalent to 9.33% pre-tax at the 39.6% marginal income tax rate, and 10.0% if the investor is subject to the 3.8% Medicare surtax. These pre-tax yields place the State of Illinois at similar yield levels as Greek sovereign debt. Regardless of how one feels about Illinois' fiscal troubles, this issue demonstrates the municipal market was oversold at that point. The State of Illinois bonds and the rest of the municipal market rallied after it was free to trade, and value-oriented investors returned.

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Lessons from the Recent Market Correction

It seems clear the Fed would like to begin slowing the pace of asset purchases and eventually, assuming economic conditions warrant, unwind their extremely easing monetary policy. We view the market activity over the last several weeks as a "trial run," both for the market and the Fed as to how to proceed toward this goal. It is important for investors to consider the following points regarding their fixed income portfolios over the next several months and years as this process occurs:

1. **Sensitivity to the Fed** – It is clear the market is on heightened alert to any change in Fed policy. Even the *possibility* of a modest reduction in the monthly Fed asset purchases caused havoc. This will be an ongoing communication challenge for the Fed, leading to higher volatility for fixed income investors.
2. **Markets Anticipate and Overshoot** – The bond market has historically anticipated more Fed action, and sooner, than typically occurs. In 2012 Treasury yields had already reached their lowest point well before the Fed announced their monthly asset purchases. Recent market action has pushed yields higher well ahead of even the possibility of a reduction in purchases. Investors can benefit from this in that it creates a positively sloped yield curve, creating the opportunity to enhance return by rolling down a steep curve.
3. **Stay Liquid** – Holding too much cash in a steep yield curve environment is costly in terms of lost yield. Yet, not having liquidity when it is needed could prove even more costly. In what is likely to be a more volatile market going forward with yields trending higher, having sufficient liquidity in a portfolio is critical.
4. **Yield Creates Demand** – There is a seemingly insatiable demand for income. As yields fell in recent years, investors were forced to seek non-traditional income choices. But as yields rise on core income products, we are likely to see investor demand return. When higher-quality, tax-free yields approach 5.0%, there is likely to be significant support for the municipal market.

There is a seemingly insatiable demand for income.

Credit Updates

A Tale of Two Bankruptcies: Jefferson County and Detroit

One municipality appears poised to exit bankruptcy while another seems likely to take its place. Jefferson County, Alabama recently filed its "plan of adjustment" with the bankruptcy court after reaching agreement with its major creditors. The county's largest creditor, J.P. Morgan, agreed to forgive $842 million of debt, 70% of the value of the $1.2 billion sewer debt they hold. A group of hedge funds also owns $872 million of sewer debt, much of it acquired in the secondary market at discounted prices, and will collect 80% of what they are owed. The hedge funds have also agreed to backstop the debt that will ultimately refinance the outstanding sewer debt, if the plan is approved. Sharing in the pain are the local sewer customers who will see 7% annual rate increases for the next four years. If the judge approves the restructuring plan near year-end, it will have been approximately two years since the original Chapter 9 filing in November 2011.

> If Detroit files Chapter 9, it will be the largest municipal bankruptcy in U.S. history.

As Jefferson County nears the end of its long road to recovery, Detroit appears likely to be starting down the same path. If Detroit files Chapter 9, it will be the largest municipal bankruptcy in U.S. history. Michigan's Governor Rick Snyder recently appointed Kevyn Orr, a respected bankruptcy attorney, as the Emergency Manager to oversee the city's restructuring. Despite having broad powers to renegotiate contracts, it seems very unlikely that he will be able to get unions, bondholders and other creditors to voluntarily agree to cuts outside of bankruptcy, particularly given the steep cuts he has proposed for some creditors. His Proposal For Creditors, released on June 14, appears to favor employees and residents over debt holders. In the proposal, unsecured creditors could receive less than 10 cents on the dollar while Orr has proposed spending $1.25 billion over ten years to improve the safety and infrastructure of the city, providing residents a viable future. Emergency Manager Orr said, "We have to strike a balance between the legacy obligations to our creditors, to our employees and retirees and to our duty as a city to 700,000 residents for lights, police, fire, emergency management and cleaning the streets." The city already defaulted on a $39.7 million payment on fund pension debt, at Orr's direction, and has stated he will stop all other payments on unsecured obligations during the negotiation process.

One of the most controversial parts of Orr's plan is his attempt to treat all unsecured debt in the same manner. it is unprecedented in the post-Depression municipal era to lump leased-back debt, limited-tax GO and unlimited tax GO debt together on a parity basis. Should this stand, it could have far-reaching consequences for other fiscally distressed municipalities, but investors are skeptical of his ability to do this. It will also be an important case study for the bond insurers as they have exposure to the unlimited tax GO debt as well as a majority of the water and sewer debt. Investors were comforted somewhat that $5.4 billion of water and sewer system debt was considered "secure" in his plan, indicating that revenues of the system would continue to flow unimpaired to bondholders, even under a bankruptcy filing. This is not to say the system will be left out of the restructuring plan altogether. It is the most valuable asset the city has and will undoubtedly be used in negotiations with creditors. All interested parties should prepare for a long legal battle, the only winners of which may be the lawyers.

Performance and Strategy

Fund Performance as of June 30, 2013

Fund / *Index*	Share Class	Inception Date	Ticker	As of June 30, 2013 (%) 1 Month	YTD	Returns as of June 30, 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	-0.22	0.18	0.75	1.43	N/A	N/A	1.54	0.38	0.31
BMO Ultra Short Tax-Free Fund	Y	09/30/09	MUYSX	-0.24	0.16	0.60	1.18	N/A	N/A	1.31	0.63	0.56
Blended Benchmark [2]				*-0.02*	*0.16*	*0.33*	*0.51*	*N/A*	*N/A*			
BMO Short Tax-Free Fund [3]	I	11/29/12	MTFIX	-0.97	0.07	N/A	N/A	N/A	N/A	0.81	0.78	0.40
BMO Short Tax-Free Fund [3]	Y	11/29/12	MTFYX	-0.99	0.00	N/A	N/A	N/A	N/A	0.73	1.03	0.55
Barclays Short (1-5 Year) Municipal Index				*-0.67*	*-0.06*	*N/A*	*N/A*	*N/A*	*N/A*			
BMO Intermediate Tax-Free Fund [4]	I	12/27/10	MIITX	-2.53	-2.22	0.65	4.44	5.60	4.18	4.64	0.45	0.45
BMO Intermediate Tax-Free Fund	Y	02/02/94	MITFX	-2.64	-2.31	0.44	4.34	5.54	4.15	4.62	0.70	0.55
Barclays U.S. 1-15 Year Blend Municipal Bond Index				*-2.08*	*-1.95*	*0.27*	*3.80*	*4.94*	*4.11*			

Other Benchmarks as of June 30, 2013

	As of June 30, 2013 (%) 1 Month	YTD	Returns as of June 30, 2013 (%) 1 Year	3 Year	5 year	10 Year
Barclays U.S. 1-10 Year Blend Municipal Bond Index	*-1.61*	*-1.34*	*0.34*	*3.36*	*4.60*	*3.84*
Barclays U.S. Municipal Bond Index	*-2.83*	*-2.69*	*0.24*	*4.46*	*5.33*	*4.42*

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

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. We focus 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 June 30, 2013

AAA Yields

Year	Current	Change 1 Mo	Change 3 Mo	Change 1 Yr
2	0.50%	*0.21%*	*0.19%*	*0.18%*
5	1.40%	*0.46%*	*0.56%*	*0.61%*
10	2.56%	*0.47%*	*0.65%*	*0.70%*
30	3.83%	*0.59%*	*0.74%*	*0.67%*

Source: InvestorTools® Perform

Cross-Market Values

Year	Current (1-Year Averages) Muni/Treasury	Current (1-Year Averages) Muni/Corporate
2	140% (121%)	81% (85%)
5	100% (101%)	78% (76%)
10	103% (100%)	87% (82%)
30	109% (99%)	95% (86%)

Source: InvestorTools® Perform and Bloomberg

Yield Curve Data as of June 30, 2013

Slope Changes

	Current	Change 1 Mo	Change 3 Mo	Change 1 Yr
Wkly–2's	0.30%	*0.06%*	*0.06%*	*0.12%*
2–5's	1.04%	*0.46%*	*0.56%*	*0.61%*
2–10's	2.06%	*0.26%*	*0.46%*	*0.52%*
2–30's	3.33%	*0.38%*	*0.55%*	*0.49%*

Source: InvestorTools® Perform

Performance By Duration

Year	1 Mo	3 Mo	1 Yr
0–3	*-0.70%*	*-0.52%*	*1.22%*
3–6	*-2.69%*	*-2.76%*	*0.80%*
6–10	*-4.28%*	*-4.89%*	*-1.19%*
10+	*-8.34%*	*-8.47%*	*-3.27%*

Source: Barclays Point

Credit Data as of June 30, 2013

Current Rating Spreads

Year	Current (1-Year Averages) AAA–A	Current (1-Year Averages) AAA–BBB
2	0.21% (0.25%)	0.76% (0.83%)
5	0.44% (0.51%)	1.23% (1.42%)
10	0.75% (0.70%)	1.39% (1.52%)
30	0.75% (0.70%)	1.17% (1.37%)

Source: InvestorTools® Perform

Performance By Quality

Rating	1 Mo	3 Mo	1 Yr
AAA	*-2.18%*	*-2.49%*	*-0.26%*
AA	*-2.68%*	*-2.92%*	*0.00%*
A	*-3.02%*	*-3.10%*	*0.98%*
BBB	*-4.17%*	*-3.56%*	*0.26%*

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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