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THE VIEW

"An investment in knowledge always pays the best interest" - Ben Franklin

Municipal Minute

Much has been written about the current financial condition of California. Our state is dealing with a serious budget shortfall that has either directly or indirectly affected all of us. Most other state budgets have been challenged as well and are dealing with the same issues to one degree or another. This begs the question - will municipal bonds continue to be a good place to direct investment dollars?

First, a quick review:

Municipal bonds are debt obligations issued by state and local municipalities and agencies. The national municipal marketplace is approximately $2.7 trillion in size and dates back to the early 1800's. Funds to repay the debt are generated by either tax revenue or the revenue generated from a particular entity or project. There are two basic types of municipal bonds, General Obligation bonds (GO's) and Revenue bonds. State issued GO's depend on sources like sales, income and real estate taxes. Revenue bonds depend on revenue from an entity or project. Examples at the entity or project level would include revenues generated by usage fees for water, electricity or a toll-road. These revenue bonds can also be viewed as either essential or non-essential service bonds. The water and power examples would be considered an essential service, while the toll-road is not. Municipal bonds are utilized within the fixed income component of an investment portfolio to provide a reliable tax advantaged cash flow and diversification.

The current economic downturn has had a negative effect on almost all revenue sources. Taxes and usage fees are both down. California reported a 19% drop off in total revenues from $103 billion in 2008 to $83 billion in 2009. Unfortunately, the cost to run a municipality rarely goes down due to the nature of their payment obligations.

Now back to the question. We believe that municipal bonds, California based, as well as those domiciled elsewhere, will continue to be an important component of diversified investment portfolios. Most municipal bonds pay income that is exempt from federal and state tax (income is state tax-exempt for an investor residing in the state of issuance). A tax-exempt yield of 4% is roughly the same as a taxable yield of 6.6% for an investor in a 40% combined state and federal bracket. The current fiscal condition of our nation and California dictate that tax rates will go up from current historically low levels, the only question is how much? All other things being equal, a rise in tax rates makes a tax-exempt yield more valuable. Municipal bonds have historically enjoyed a very low incidence of default, and should continue to be a competitive alternative for investment assets.

While most municipal bonds pay income which is tax-exempt, some pay income which is taxable. Starting in 2009 a type of municipal bond called Build America Bonds (BAB's) were introduced. BAB's accounted for about 30% of newly issued municipal debt during 2009. This has the effect of substantially increasing the number of potential investors in municipal bonds because these issues can now be a competitive alternative in tax-deferred accounts. This also has an effect on the supply/demand aspect of the municipal market. Less issuance of new tax-exempt debt, just like an increase in tax rates, has a positive effect on existing debt.

We believe that the main concern for investors in the municipal market will be the type of municipal bond issuer and their underlying financial strength. In general, essential purpose revenue bonds, like those described above, larger school system bonds, dedicated tax receipt issues, pre-refunded, state GO's (California's and other state GO's), and other selected issuers will continue to be a good alternative for fixed income investors.

Back to the Golden State:

California is the largest state economically in the United States and represents approximately 13.5% of the nation's GDP with approximately 12% of the population. It's also the largest issuer of state debt in the US as well, accounting for around 15% of total national municipal bond issuance in recent years. California requires a balanced budget, as do most municipalities, but unlike most, requires a 2/3 vote of both houses in order to pass a budget. This makes the California budget process unusually difficult. California's financial woes have earned the state the lowest credit rating of any state as determined by Moody's, an independent bond rating agency.

Fortunately, California has a steadfast constitutional commitment to its debt obligation and defines its top

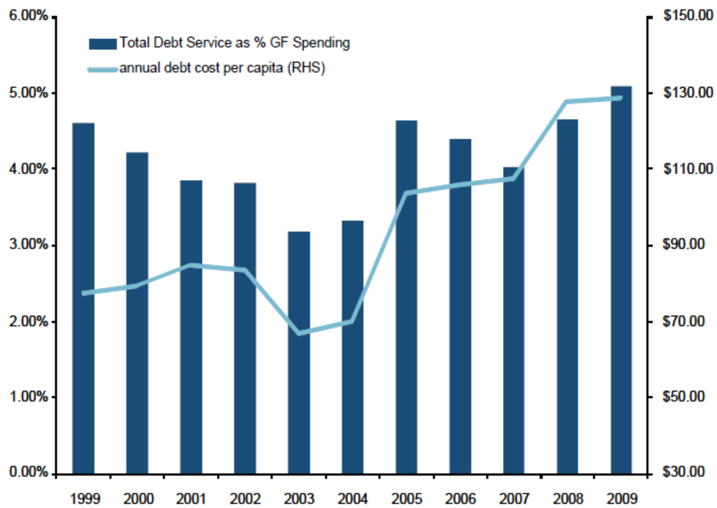

Chart courtesy of Goldman Sachs

two budget priorities as education and debt service. This means that California must deal with its debt service before most basic programs or services can be funded.

Despite the negative effects caused by the economic downturn, California's annual debt service amounts to less than 5% of the general fund revenues and currently appears very manageable (see chart).

It should be noted that municipalities, at all levels, depend on access to the credit markets just like companies in the private sector. Should a municipal bond issuer fail to make a timely payment on interest or principal, their ability to attract funds in the future would be negatively affected. At a minimum, the cost to borrow would go up. For this reason among others, all municipalities place a very high priority on their debt obligations. It should also be noted that, by definition, municipalities perform a public function. This "public good" aspect is what leads to the favorable tax treatment on interest paid to investors, which then leads to a lower borrowing cost for the municipality. On the other hand, it also results in a reduced number of choices that a municipality has in the event of financial hardship. Municipal entities are not allowed to just close their doors and cease to exist the same way a private sector entity can. Municipal bankruptcy filings revolve around restructuring, not liquidating. Restructuring is better for bond holders.

We will continue to view municipal debt as a viable alternative for income oriented investors and as a tool for diversification. Economic conditions dictate that we continue to diversify by type, maturity, coupon and location. Bond ownership can be in the form of individual bonds or existing portfolios such as mutual funds, including exchange-traded funds. Selected alternatives are based on our clients' needs and our expectations for future market activity. We think that with interest rates at historically low levels, flexibility will be key.

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Sources: Bureau of Economic Analysis, State Audit, State Controller (12-31-2009), Bureau of Labor Statistics (Feb 2010), State prospectus, Legislative Analysts Office (1-1-2010)