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THE VIEW

*"As the builders say, the larger stones do not lie well without the lesser." - **Plato***

Municipal Minute

There has been a lot of new information since we last visited this issue in April. The bottom line assessment is still the same in that we think select municipalities offer an attractive alternative for a fixed income portfolio. California general obligation debt, in particular, can still be considered attractive.

Our focus in the municipal area going forward will continue to be higher quality essential use type bonds (water, electric, sewer, etc.) and bonds backed by municipalities with a broad-based taxing authority. Issues backed by a broad-based taxing authority would include state and general obligation bonds, large city bonds and large school system bonds. Municipal obligations that we expect to avoid include real estate backed issues, hospital bonds, smaller community college districts and, in general, smaller municipalities that lack a broad tax base.

California approved its annual budget two weeks ago, approximately three months late. This was late even by California standards and, what is even worse, the budget that was passed was essentially the same as a budget submitted back in June. So why the delay and why am I bringing it up? I bring this up because I think the details in the budget help explain the situation that California and many other states face. Municipalities are facing declining revenue from income, real estate and business taxes. While revenues are going down, expenditures are either staying the same or are going up. Remember that municipal expenses are very sticky. Municipalities don't want to reduce services that they already provide. Add to that the imbedded retirement benefit obligations many municipalities are dealing with, and this could be a difficult period for much longer than we wish to believe.

California's budget is expecting \$92.3 billion in receipts and \$92.0 billion in spending [(1)]. The budget impasse was over an expected \$19 billion deficit. The way they agreed on a "balanced" budget was not to generate any new fees or taxes, or to make additional major spending cuts, but to instead change the assumed amounts for several key items. For example, they changed what they expect the state to receive from the Federal Government during the next 12 months from an original amount of $3.3 billion to $5.3 billion. No reason for the change was given, they just changed it. They also found a way to delay $2 billion in payments to the school systems for grades K-12 and push the payments into next year's budget. They are also now expecting a quicker recovery in the overall economy such that an additional $1.4 billion in tax revenues will be generated. The point of this is that it appears creative accounting was the main tool used to "balance" California's state budget.

It should be noted that California is not alone in their assumptions for economic growth. Moody's recently reported that no state has built a budget on an assumption of a double-dip recession in 2011. What happened to "hope for the best, but plan for the worst" thinking? We can only hope that their assumptions will be correct.

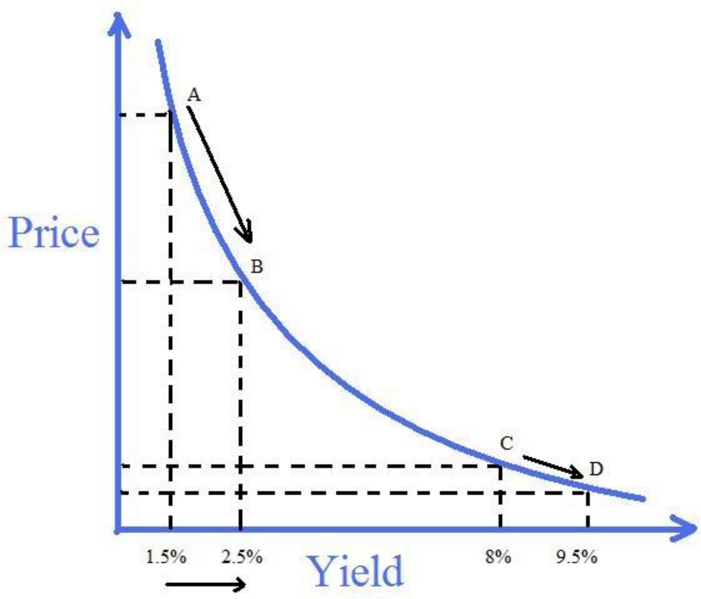
It also appears state budgets are becoming more dependent on assistance from the Federal Government and that local municipalities are becoming more dependent on funds from the state. Through the American Recovery and Reinvestment Act of 2009, the Federal Government directed $135 billion in stimulus funding to the states, primarily for Medicaid and education programs through June 2011. We wonder what happens if this stimulus is not extended? A survey released last week by the National League of Cities reported that almost 90% of city CFO's surveyed said that their city was less able to meet their obligations this year than last and they don't expect any improvement in 2011 [(2)].

This all leads back to the thought that municipal bond ownership going forward should focus on revenue bonds with a well-defined source of revenue to repay the bonds (essential use bonds) and municipalities with a broad-based taxing authority. Please remember these are generalities that serve as a starting point for discussion. All municipal issuers are unique in that all have the ability to run their own finances, though some chose to be more fiscally conservative than others.

When comparing municipals to similar quality corporate bonds, the municipal obligation does have an important advantage in that municipalities don't file bankruptcy and then liquidate assets the way corporations do, they can't. Municipalities exist to perform a public function. Another advantage of municipal finance/debt over corporate or sovereign (federal government) alternatives is a much lower degree of what's called "rollover risk". Rollover risk is the risk that a borrower faces when it has to refinance maturing debt. When debt that needs refinancing matures during a "difficult" time for either the issuer or the fixed income markets (generally when there is a lack of liquidity) a very difficult situation may develop for the issuer. Borrowers (issuers) unexpectedly facing the prospect of failing to roll over existing debt was a primary cause of the financial crisis of 2008 and the sovereign debt crisis earlier this year in Greece. Because municipal borrowers in the U.S. generally plan to pay off debt steadily over time from taxes and other normal revenues, rather than planning on rolling the debt over at maturity, rollover risk has been less with municipal investing than with other bond alternatives.

Prices of municipal bonds have risen in general over the last couple of years and there are several reasons for this. First, and foremost, interest rates have declined (the old inverse interest rate vs. bond price relationship). Second, there is a very real supply/demand imbalance in the municipal bond market. A new type of municipal bond called Build America Bonds (taxable municipal bonds) has made up around 25% of all new municipal bond issuance over the last couple of years [(3)]. A reduced issuance of tax-exempt municipal bonds has been the result. Third, the general view that tax rates are going up has helped place a premium on tax-exempt income.

Low current interest rates are a concern at this point because of the inverse relationship between interest rates and bond prices. While we don't expect rates to rise a lot soon, they will rise at some point. When they do rise, all bonds will feel the effect to some extent. The longer the time until a bond matures and the lower the coupon rate, the more of an effect the rate change has on a bond's price. Also, the lower the general interest rate level, the more pronounced a rate change is.



Looking at the above chart you can see that going from 1.5% to 2.5% (a 67% change in interest rate) has a much bigger price affect (see A-B in chart) than going from 8% to 9.5% (a 19% change in the interest rate and C-D in chart). In the current low-yield environment being in the "wrong" types of bonds could lead to price volatility characteristics similar to stocks, catching investors way off guard.

We continue to believe municipal bonds are a good alternative for an income oriented portfolio. But, we have become very particular in our choices of specific municipal bonds.

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1. California Budget package 201-2011, OC Register 10-7-2010

2. National League of Cities, Nations Cities Weekly 10-6-2010

3. MMD Interactive, UBS WMR 10-1-2010