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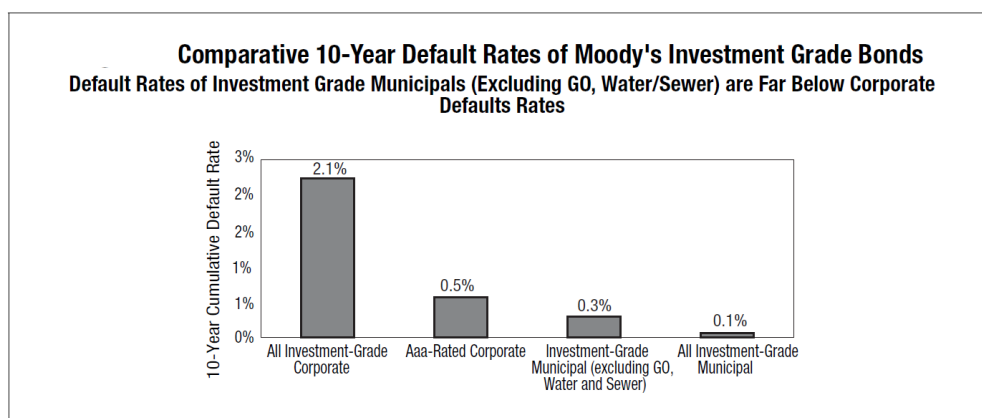
Market Commentary: Municipal Bonds

Greg Friedman, President and Chief Investment Officer

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In a letter to a friend, Mark Twain stated that, “Reports of my death have been greatly exaggerated.” Twain’s famous phrase about inaccurate rumors of his death neatly expresses Greycourt’s view of recent crisis in the municipal bond market. For the past several months, the airwaves have been awash with reports about the dire state of fiscal affairs facing state and local governments. Of particular impact have been predictions by several notable market analysts (especially Meredith Whitney and Nouriel Roubini) forecasting a sharp spike in the pace of municipal defaults – events so rare in the past as to be deemed all but non-existent. Since private investors rely heavily on tax-exempt municipal bonds to form the core of their fixed income allocations, many are understandably concerned about the true extent of reported distress among municipal issuers and the risks that such distress may pose to their portfolios. To understand the true nature and full extent of the risks facing municipal bond investors today, it is useful to examine briefly the two basic components of bond risk: default risk and interest rate risk.

For most bondholders, failing to receive principal and/or interest payments due from a borrower (i.e., “default risk”) represents their greatest source of risk. Not all bonds are deemed to expose investors to default risk. For example, U.S. Treasury and U.S. agency securities are deemed so safe that investors do not demand extra return to compensate them for default risk. In the past, municipal bonds were viewed in much the same way, since actual defaults of municipal bonds have been extremely rare. According to a 2007 study conducted by Moody’s, a mere 41 investment-grade tax-exempt bonds defaulted from 1970 through 2006. Of these, only a single issue represents a default by a state, city or local municipality – and that one was cured within 15 days. Collectively, these 41 defaults represent a microscopic default rate for the investment-grade tax-exempt bond market: less than 0.1%. By comparison, taxable investment-grade corporate bonds exhibited a 2.1% default rate over the same period. Of course, past is not necessarily prologue and it is the fear of an unprecedented wave of municipal bond defaults in the future that has so concerned investors.



Source: Moody’s Rating Methodology Report, March 2007

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Undoubtedly, states and local governments are grappling with large budget deficits that require them to make painful choices. For example, facing a \$15 billion budget deficit, the Illinois legislature recently voted to increase that state's income tax rate by a whopping 66%. Grappling with a \$25 billion budget hole, California is currently negotiating the details of a series of spending cuts and a 5-year extension of a temporary tax increase imposed in 2009. Likewise, New Jersey's governor Chris Christie is proposing cuts to state employee payrolls amounting to \$2.6 billion as he seeks to address a \$10.5 billion deficit. The list goes on. But what clearly is an ugly situation for state and local residents is not necessarily dire for bondholders. Let's look at some facts below¹.

1. Some make an analogy between the default risks facing municipal bondholders and those facing creditors of heavily-indebted sovereign nations like Ireland, Portugal, Greece and Spain. The truth is that the median state had debt of merely 7.3% of local GSP (Gross State Product). Compare this to the debt-to-GDP of Ireland (1,224%), Portugal (201%), Greece (165%) and Spain (157%).
2. Defaults often can occur because a borrower cannot repay maturing debt by issuing new bonds. The more frequently a borrower has to tap the debt markets, the greater this refinancing risk. Here, again, municipalities are in far better shape than sovereign or corporate issuers. The median weighted average maturity ("WAM") of municipal bonds outstanding is 16.2 years, far in excess of most other bond classes. The WAM of US Treasury debt, for example, is under five years.
3. It has been argued that municipalities, facing sizeable budget deficits, may be unable to pay annual bond debt service. This seems highly unlikely to us. The average cost of municipal debt service is a mere 3% to 4% of GSP. Moreover, several states, most notably California, are bound by their constitutions to prioritize debt service over most other types of expenditures.
4. Finally, some point to the growing burden of under-funded public pensions as a serious risk facing municipalities. Here we agree. It is estimated that aggregate under-funded public pension liabilities amount to between \$700 billion and \$3 trillion depending on the interest rate assumptions used to discount future benefit obligations. Clearly, inaction on the part of municipalities to address pension funding will ultimately lead to insolvency in the future. However, even if left unattended, under-funded pension obligations will not materially impact current municipal cash flows for another 10 to 15 years. Most of the bonds held by our clients mature well before this time.

Although this discussion relates to default risk, it's important to note that another major risk facing bondholders is the sensitivity of bond prices to changes in underlying interest rates ("interest rate risk"). Recall that bond prices move inversely with the direction of interest rates. In other words, bond prices fall when interest rates rise and rise when interest rates fall. Given that current interest rates are near historically low levels as the result of the US government's efforts to stimulate the economy, interest rate risk to bond holders is currently very high: i.e., rates are likely to rise in the future.

¹ The statistics on this page are courtesy of PIMCO.

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However, it's important to put the degree of that risk into perspective. Since most municipal bond investors own bonds having intermediate durations of between three to five years, the extent of potential loss due resulting from rising interest rates is actually quite modest. For example, if interest rates for a 4-year municipal bond immediately doubled from their current yield of 1.7% to 3.4% (a pretty dramatic shift), then the loss suffered by the bondholder would amount to -5.7%. Clearly, losing nearly 6% of your sleep-well money isn't a pleasant prospect, but it hardly represents a disaster. In addition, as interest rate levels rise, any maturing bonds can be reinvested at higher yields.

In conclusion, we believe that bonds, specifically municipal bonds, continue to play a central role in the construction of properly diversified portfolios. They provide cash flow, capital preservation, liquidity and protection against the risk of deflation. We believe that fears of widespread municipal defaults have been substantially overblown by the press. To be sure, municipal bond risks have increased but they remain modest relative to other forms of fixed income. Finally, the tax-adjusted yields offered by municipal bonds in today's market are significantly higher than the yields on equivalent taxable securities. We continue to recommend that investors focus on high quality general obligation and essential services municipal bonds as the core of their bond portfolios. We also continue to recommend that investors maintain shorter-than-benchmark durations in order to dampen the risks of rising interest rates.