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ASSET MANAGEMENT

The U.S. Municipal Market: Oncoming Train or Light at the End of the Tunnel?

By

The Standish Tax-Sensitive Fixed Income Team

STANDISH

Executive Summary

Amid broad-brush headlines about dire state and local finances and the possible effects on the municipal bond markets, we believe it is important to remember differentiations within the municipal market and among state and local governments. While we have long pointed to the significant long-term finance challenges facing state and local governments, especially over underfunded pensions, we believe many recent reports exaggerate the widespread nature of the problem by ignoring these differences in conditions across states and localities and indeed within different segments of the municipal market. In an effort to redress the balance of some recent reports, we seek to provide investors a more nuanced view of the municipal market. Our main views about the market can be summarized as follows. We believe:

- In general, state and local governments will remain creditworthy
- The risk of impairment for municipal state and local government bondholders is limited
- Municipal bonds are unlikely to become the next "contagion"
- The fundamentals of the municipal bond market are stabilizing
- The significant media and political attention will ultimately increase the likelihood that state and local governments will address their long-term pension obligation issues

Overview of the Municipal Bond Market

State and local governments face immediate fiscal challenges in the form of decreased revenue and others that are equally significant but longer term in nature (i.e., unfunded pension problems). We believe these pressures will continue to impact governments and impair their ability to provide services at the levels the electorate have come to expect. While revenues in some states have recently shown improvement, we remain cognizant of the risks posed by further revenue declines. Local governments would likely be the most pressured as they, in general, are dependent on state aid, which could be further reduced. If that happened, we could see a marginal increase in local government defaults because local property taxes alone most likely will not suffice to fund government services.

Additional concerns include ballooning pension liabilities. While fundamentally a long-term challenge, we are vigilant of the highly political and sensitive nature of the current debate and acknowledge that threats of not funding debt service obligations may become tied to this dilemma. The unfunded pension problem is significant. Research by Northwestern University and the University

of Chicago estimates that state pension plans are underfunded by about $3 trillion, while municipal plans are underfunded by $574 billion.[1] Without action to reduce the liability, municipal governments will face a crisis as going concerns and debt obligors.

However, we believe that the risk of impairment for municipal state and local government bondholders is limited even though there may be a marginal increase in defaults from what have historically been extremely low levels. We believe state and local government credit quality should remain strong and resilient for the following reasons:

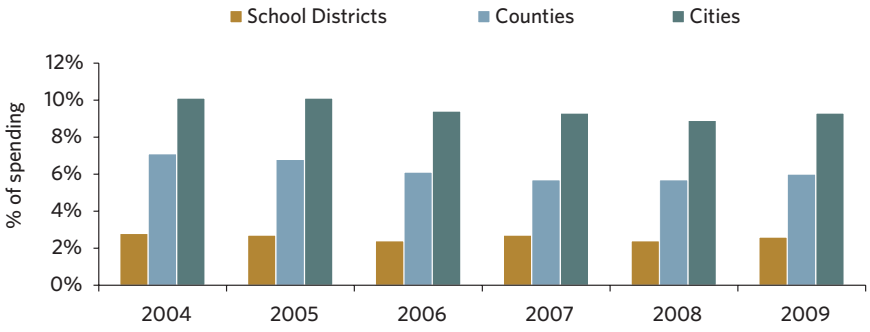
Unlimited general obligation bonds are secured by a legal obligation to raise taxes without regard to rate or limit. In some cases this protection is codified in state constitutions.

Strength of the security pledge. Unlimited general obligation bonds are secured by a legal obligation to raise taxes without regard to rate or limit. In some cases this protection is codified in state constitutions. Governments have in the past and will likely in the future cut other spending items before not paying debt service because debt service is a relatively small part of their budget and the consequences of not paying are so large. The priority to service general obligation debt is higher than almost all other government liabilities.

Political willingness to pay debt service has support. General obligation bonds are issued for specific and well disclosed purposes, and usually voter-approved by the electorate or legislature.

Debt burden remains stable. Debt service for local governments is generally a low percentage (5-10%) of a borrower's general fund budget; as a percentage of personal income, the states' median tax burden remains consistent with recent levels (Exhibit 1).

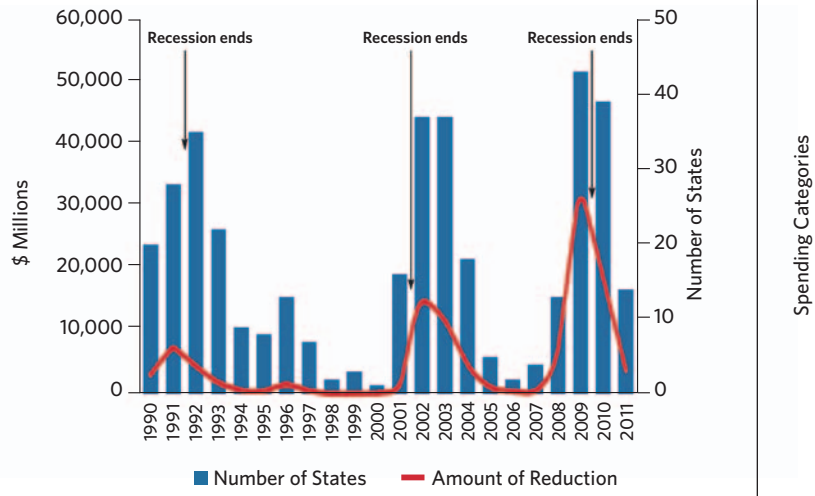
Exhibit 1 – Over the Past 5 Years, Municipal Debt Burdens Percentages Have Remained Stable and Low



Source: Merritt Data, Fiscal Year 2009

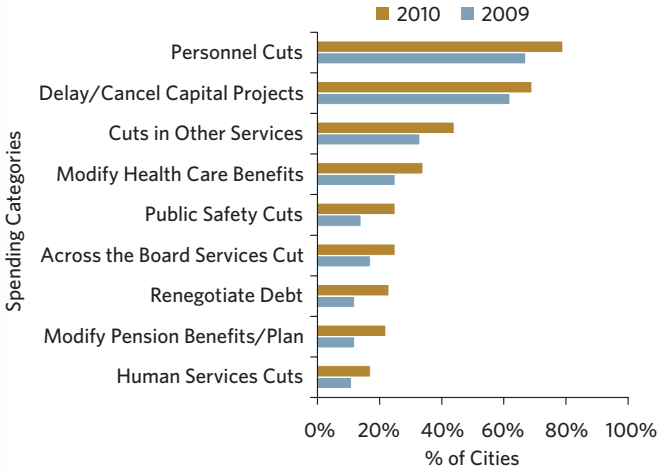
1 Robert Novy-Marx and Joshua D. Rauh, "The Crisis in Local Government Pensions in the U.S.," October 2010.

Exhibit 2 – Historically, Most States Have Acted to Quickly Reduce Budget Spending in Response to Market Recessions



Source: National Association of State Budget Officers, December 2010 Fiscal Survey of States

Exhibit 3 – Many Local Governments Continue to Reduce Spending Across the Board



Source: National League of Cities as of October 2010

It is well known that sovereign governments around the world are reeling from significant reductions in revenue as a result of the most recent deep recession even as they continue to face rising social welfare, healthcare and other ongoing obligations. Austerity measures in Europe, for example, have spawned strikes and demonstrations. In contrast, U.S. municipal borrowers have safeguards against the types of risks that sovereign borrowers face.

Governments have to, and will likely continue to, cut spending. Every state, with the exception of Vermont, has some form of legally binding budget balancing requirement.

State tax revenues appear to be stabilizing. Through the third quarter of 2010, state tax revenue increased three consecutive quarters, year over year. Additionally, the revenue increases have been broad-based, with 42 states reporting increases, while the other eight states have reported flat or decreased revenue.[2] As revenues are highly correlated with U.S. economic activity, recent positive economic reports support an optimistic, if cautious, outlook.

Are Municipals the Next Contagion?

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First, municipal bond maturities are generally longer-dated compared with sovereign debt and are also self-amortizing. This effectively helps reduce the risk that municipal governments need ongoing market access to fund their debt service payments. By contrast, sovereign debt typically is issued in a "bullet" or targeted-maturity structure and is generally shorter term by design.

2 "State Revenue Flash Report," The Nelson A. Rockefeller Institute of Governments, November 30, 2010.

Second, state and local government municipal issuers generally are not dependent on market access for ongoing operations. Sovereign borrowers typically issue debt to finance operations, while most state and local government bonds are issued for capital purposes so that issuance can be delayed or adjusted.

Finally, state and local governments generally have fewer liabilities. Sovereign governments must support broad and costly programs such as militaries, social security programs, national healthcare, and banking, while U.S. municipalities have more limited responsibilities such as the funding of schools and government offices.

We believe fundamental financial conditions for U.S. municipalities are favorable relative to the state of many European sovereign debtors. If you compare the median net-supported debt as a percentage of GDP as well as deficits as a percentage of GDP, currently these ratios are significantly lower for some of the U.S.'s largest state and local governments, as shown in Exhibit 4.

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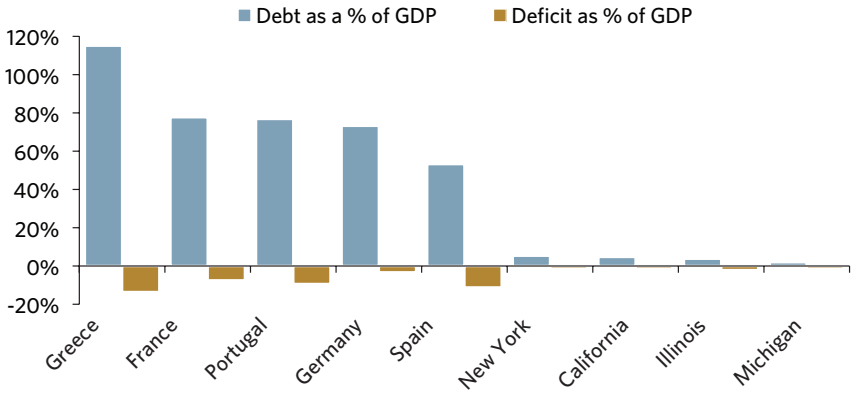
Exhibit 4 – Several Large U.S. States Have Better Debt and Deficit Ratios Versus Select European Sovereign Governments



Source: Tax Supported Debt – Moody's Investor Services – State Median Released April 2010, GDP – Bureau of Economic Analysis – Department of Commerce June 2009, Deficits – Center on Budget and Policy Priorities – Update May 2010 – Projected for 2011

State and Local Pension Funding Is a Long-Term Challenge

Unfunded pension liabilities and other post-employment benefits (OPEBs) — chiefly health insurance — have garnered increased attention as the estimated magnitude reached historic proportions. Changed accounting practices highlighted the enormity of obligations; previously, pension and OPEB benefits were treated on a pay-as-you go basis with no recognition on the state and municipal financial statements. Generally speaking, the pension liability for current retirees or employees is non-negotiable and immune from adjustment due to legally binding contracts.

The funding status of state and local government pensions took a turn for the worse in 2008. After the median funding levels peaked at nearly 90% in 2007, funding levels dropped sharply in fiscal year 2008 and 2009 as a result

of (1) massive declines in equity values and (2) widespread under-funding of annual pension contributions as large budget deficits arose. Median funding for state pensions fell to approximately 60% as of June 30, 2009. (source 2010 Wilshire Report) Estimates of the dollar amount of unfunded liabilities for state pensions alone vary from $1 trillion (using the prevailing 8% discount rate) to $3 trillion (using U.S. Treasury rates). Either way, the unfunded pension liabilities are massive in relation to the total amount of tax-supported debt outstanding at the state level, approximately $460 billion.

The significantly underfunded status of state and local government pensions will continue to be a major challenge even with an improving economy and resulting increases in tax revenues. We believe state and local governments will have to abandon their past practice of underfunding annual contributions and revise overly optimistic assumptions of investment returns. Absent significant reforms, there is a risk that the most underfunded plans such as those in the states of Illinois, Connecticut, and New Jersey may exhaust their assets and begin to pay retirees from operation budgets. Such a move would greatly undermine the state's ability to balance its budget in the future.

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Nevertheless, we believe there are several important considerations municipal bond investors need to keep in mind when considering state and local pension problems:

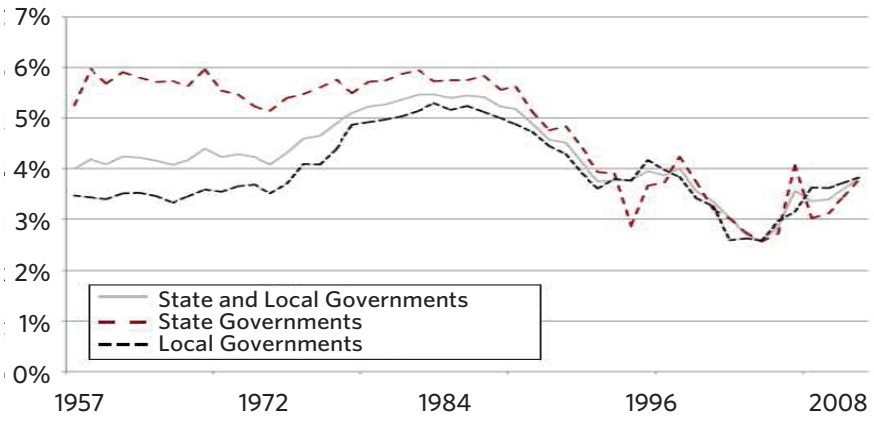
- States have increased and will likely continue to increase their annual contributions to pension funds. Pension contributions are a relatively small portion of state and local government budgets (see Exhibit 5), and there is capacity to step up contributions.
- Despite the headlines, many states are well positioned with reasonable funding ratios as of October 2010. These include California (87%), Texas (84%), Florida (87%) and New York (84%).[3]
- Pension liabilities are long term in nature, and we believe current reforms will have a multiplier effect on future liabilities.
- In 2010, 18 states enacted reforms such as reducing benefits for new employees, raising the retirement age, increasing employee contributions, reducing cost of living adjustments and preventing a "spiking" of salaries to increase benefits.[4]

3 Numbers taken from individual state fiscal year annual financial reports and "2010 State Pension Funding Review," Loop Capital Markets, October 2010.

4 U.S. Federal Reserve.

Essential service revenue bonds, such as water and sewer systems, municipally owned electric systems, airports, toll roads, hospitals and colleges and universities are secured by and payable from the dedicated revenue from the project or service provided.

Exhibit 5 – Government Pensions Have Historically Been a Manageable and Low Portion of State and Local Budgets



Source: Center for Retirement Research, 2010

We believe the significant media and political attention paid to this problem greatly enhances the likelihood that state and local governments will take meaningful steps to address their pension obligations.

Deconstructing the Municipal Bond Market

It is also important to remember that the municipal marketplace is enormous and heterogeneous, with a wide range of issuers and purposes. There are two major classes of municipal bonds: general obligation (or "GO") bonds, which are supported by state or local taxes; and revenue bonds, which are issued by a governmental entity (such as a water utility). The interest is paid by the revenue generated from the business that backs the obligation. Revenue bonds comprise more than half of the long-term municipal bond market and are not reliant on taxes for debt service and principal repayment. Essential service revenue bonds, such as water and sewer systems, municipally owned electric systems, airports, toll roads, hospitals and colleges and universities are secured by and payable from the dedicated revenue from the project or service provided. On balance, we favor essential service revenue bonds over tax-backed issues for the following reasons:

- Essential service revenue bond issuers generally can raise fees and charges to maintain sufficiently high cash flow to comply with bond covenants. (For example, municipally owned utilities do not require utility commission approval to raise rates).
- They have separate and distinct revenues and expenditures from general government operations.
- They generally have more frequent and transparent financial and operating disclosures, as well as stronger underlying fundamentals.

According to Thomson Reuters, cities and states sold over $117 billion of BABs in 2010, making up almost one-third of the year's $430 billion total new supply, mostly concentrated in long term debt.

- Revenue bonds may have access to unrestricted cash and investments well in excess of the amount of debt issued, especially those issued by large hospital systems and well-established universities.
- They generally experience more stable revenue streams and financial ratios during economic cycles.[5]

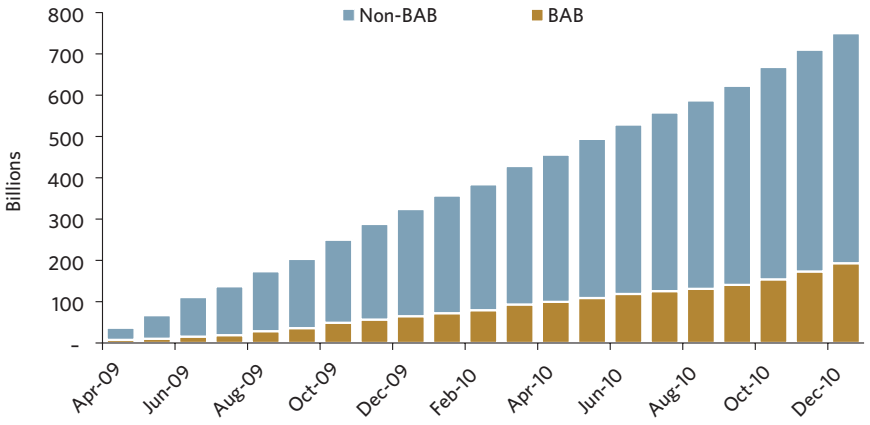
The major weaknesses to consider regarding essential service revenue bond issuers are:

- Narrower revenue pledge, which may make them more susceptible to adverse single-industry events.
- Lack of taxing power
- Some issuers, notably hospitals and colleges and universities, face competition.

Taxable municipals issued under the Build America Bond (BAB) program substituted for significant tax-free municipal bond issuance. According to Thomson Reuters, cities and states sold over $117 billion of BABs in 2010, making up almost one-third of the year's $430 billion total new supply, mostly concentrated in long term debt. Tax-free municipal bond issuance was at its lowest figure since 2001 and represented a 15% decline from 2009.

The expiration of the BAB program should result in a decline in overall new issuance for 2011, however, the tax-exempt portion of that supply should normalize to historical issuance patterns as states and local governments continue to fund capital programs. While municipal issuers have responded to a steep yield curve with greater issuance in shorter maturity ranges, this is likely to be tempered in 2011, municipalities today aim to avoid the perception of concentrated debt service and "rollover risk." Tax-exempt issuance in longer-dated maturities should continue in place of the void left by BABs, thereby maintaining a steep tax-exempt yield curve.

Exhibit 6 – Build America Bond Growth During 2009 and 2010



Source: Bloomberg, Standish as of December 31, 2010.

5 Merritt Data, FY 2010.

The Retail Investor. The retail investor drives what we believe is the key risk in the municipal market – liquidity. According to the Federal Reserve, retail investors currently comprise 70% of municipal bond ownership, including direct ownership and indirect ownership through mutual funds.

Retail investors have demonstrated powerful and uniform responsiveness to perceived risk and return, therefore commanding significant influence on price behavior. Recently, long-term and high yield municipal funds have experienced significant redemptions, largely to the benefit of equities and direct ownership of intermediate municipal bonds. This has resulted in a dislocation of supply and demand, weakening liquidity in the market. We expect this condition to persist in the near term, especially as the media provides frequent (and in our opinion, often unbalanced) reporting on state and local government credit quality. To the extent that investor sentiment becomes irrational, liquidity conditions should deteriorate further.

We believe investors should be encouraged by a renewed sense of urgency among municipalities to address fiscal challenges. The municipal market has proven resilient, as reinvestment of coupon and maturities as well as seasonal patterns of new issue supply have historically offset selling pressure.

We believe investors should be encouraged by a renewed sense of urgency among municipalities to address fiscal challenges. The municipal market has proven resilient, as reinvestment of coupon and maturities as well as seasonal patterns of new issue supply have historically offset selling pressure. As well, higher interest rates resulting from weak markets have drawn in non-traditional buyers such as opportunistic "crossover" funds. Property and casualty companies are not expected to be a growing source of demand for municipals due to weak pricing power and profitability for the coming year.

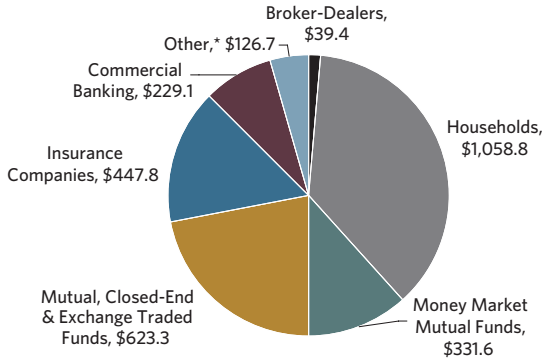
Price Volatility. After hitting historically low levels this past spring, the trend for realized volatility reversed in the second half of the year.[6] While still below the peaks of 2008, volatility in the fourth quarter reached historically high levels, especially after adjusting for low yields. Underscoring the stress in the market, the yield differential between lower-rated investment grade bonds (AA to BBB) and AAA bonds widened dramatically, driven primarily by technical factors. We expect volatility to stabilize, albeit at higher levels than in prior years. However, individual investors exiting the municipal market in response to negative headlines regarding state and local credit conditions could set off renewed volatility. Ultimately, we expect credit spreads to tighten as these municipal market headlines lose credibility with individual investors.

6 Federal Reserve Bank report.

Over the last decade we have been repeatedly reminded that events that cause financial crises are difficult to spot in advance. As a result we are always monitoring possible risks that could affect the municipal market.

Exhibit 7 – Retail Investors Comprise Greatest Share of Municipal Bond Ownership

Total: $2.86 Trillion



*Other includes: Rest of world ($52.0), Nonfinancial Corporate Business ($25.7), Savings Institutions ($10.2), Nonfarm Noncorporate Business ($4.8), State & Local Governments ($7.8), GSEs ($26.2)

Source: Federal Reserve as of September 30, 2010

Standish Remains Cognizant of Broad Market Risks

Over the last decade we have been repeatedly reminded that events that cause financial crises are difficult to spot in advance. As a result we are always monitoring possible risks that could affect the municipal market. These include:

A Double-Dip Recession. If the U.S. economy were to fall back into recession, state and local government finances would face severe pressure: the recent upward trend in revenue collections would be choked off and spending needs for social services would rise. In addition, the cushion provided by rainy day funds in the last recession would no longer be available to fill budget gaps. Continued concern over the federal budget deficit would hamper federal assistance in the event of a state or city fiscal emergency.

Higher Interest Rates. Whether resulting from a spike in inflation or a downgrading of U.S. credit ratings, higher interest rates are a negative for bond valuations in general, regardless of credit quality.

Moody's recently warned that a continued rise in U.S. debt to GDP could lead to a ratings downgrade for Treasuries. We believe this outcome, which would be bad for all dollar-denominated assets, including municipal bonds, could be avoided through a combination of economic growth and fiscal austerity.

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The potential impact of rising inflation on municipal credit quality is mixed. State governments relying on elastic sales and income taxes would see their revenues climb quickly as the price index rises. Expenses with no cost-of-living adjustments would increase more gradually, providing potential budget relief. Local governments might see less benefit from inflation, as property assessments and property taxes generally lag inflationary home price adjustments. Some revenue bond sectors, such as electric and gas utilities, could be pinched by rising raw material costs, but would benefit as a fixed-rate debtor, having already financed required infrastructure.

Banks Retreat from the Municipal Market. Both Fitch Ratings and Moody's Investors Service have warned that the upcoming expiration of credit facilities backing floating rate municipal bonds (estimated at $350 billion to $400 billion outstanding as of September 2010) could pose credit risks in the next couple of years. According to Bank of America Merrill Lynch, $109 billion of bank credit facilities expire in 2011. Some analysts have noted that in light of stricter capital requirements as well as concerns over municipal credit quality, banks may be less willing to renew the credit facilities at expiration, potentially forcing issuers to convert the bonds to long-term fixed rate instruments.

Despite these warnings, we believe the impact of potential bank credit facility expirations can be absorbed by the issuers. The most frequent issuers of floating rate debt tend to be those in the healthcare and higher education sectors. Most of these issuers are among the stronger credits in those sectors and we believe will generally have sufficient cash flow and liquidity to withstand higher financing costs that may result. State and local governments comprise a small percentage of the floating rate market.

Weak credit issuers are at risk for excessive funding costs or the inability to access long-term debt markets in lieu of short-term funding.

Revision of U.S. Bankruptcy Code to Allow Chapter 9 Filing for States. Recently anti-tax groups and some Republican political leaders have argued that U.S. states should be allowed to file for bankruptcy under Chapter 9. This would effectively send the message that there is no option for states to seek relief from the U.S. federal government in the event of a fiscal crisis. Chapter 9 could also force the issue of funding public pension and healthcare liabilities, either motivating states to improve funding rates, or providing a lever to renege on such promises in the event of a workout. Should this proposal gain traction, it would likely undermine investor confidence in tax-backed municipal credits, and severely exacerbate the current poor liquidity conditions in the municipal market. Under current bankruptcy law, local general obligation bondholders are considered unsecured creditors.

As a practical matter, we believe Chapter 9 for states is unrealistic, as it is a voluntary, lengthy and expensive process due to the conflicting interests of politicians, financial managers, unions, voters, bondholders and a plethora of other creditors. We have already seen the difficulties the city of Vallejo, California, has encountered after declaring bankruptcy in 2008. A recent report detailed the severe cuts in public safety services, the millions of dollars spent in legal fees, and nearly three years of uncertainty for creditors, including current employees and retirees.[7] Under the plan of adjustment Vallejo filed in U.S. Bankruptcy Court in January, general unsecured creditors would collect 5 percent to 20 percent of their claims. Some observers have used Vallejo as a cautionary tale for overstating the benefits and understating the costs of bankruptcy.[8] In the event, states like California, New Jersey and Illinois that might be considered prime candidates for bankruptcy have already begun to seek alternative solutions to their fiscal problems through deep spending cuts, higher taxes and pension reform.

The Political Wild Card

As states prepare more austere budgets to confront their fiscal problems, voters and public employees may protest forcefully, which could disrupt political support for spending cuts and higher fees and taxes. So far, in the third straight year of budget deficits, the public response to remedial actions has mostly been orderly and muted. But there could be a necessary trade-off between reducing debt service and abrogating OPEB and union benefits.

7 Jonathan Weber, "For Vallejo, Bankruptcy Isn't Exactly a Fresh Start," *The New York Times*, January 22, 2011.

8 Alison Vekshin and Martin Z. Braun, "Vallejo's Bankruptcy 'Failure' Scares Cities Into Cutting Costs," *Bloomberg*, December 14, 2010.

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