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Is it Armageddon or an opportunity?

- In Defense of Municipal Bonds

Last December, a well-known market analyst made a startling prediction that rattled the municipal bond market. Appearing on "60 Minutes," the analyst predicted widespread defaults among municipal bond issuers. She claimed that 50 to 100 sizeable defaults, representing hundreds of billions of dollars in municipal bonds, would occur within the next year.

Well, the clock is ticking on that prediction, and approximately four months later, we have yet to see any uptick in sizeable defaults. In fact, there have been very few defaults, period. Despite some legitimate concerns about the fiscal health of many municipalities, at Adviser Investments we do not expect to see a surge in municipal bond defaults later this year or anytime soon.

To understand our thinking you first must understand some basics about how the municipal bond market operates.

The total size of the U.S. municipal bond market is roughly \$3 trillion dollars and is made up of tens of thousands of bonds from thousands of issuers. State and local governments issue municipal bonds to pay for new bridges, roads, schools, water treatment plants, and other projects.

The most common types of municipal debt are general obligation (GO) and revenue-backed bonds. General obligation bonds are backed by the issuer's ability to levy a tax (income, sales or add-valorem property taxes). Revenue bonds are backed by the revenues of the issuer. For example, the fees you pay for water use may be used to pay interest on bonds that were issued to build the water-treatment plant that supplies your drinking water.

Historically, defaults in the municipal bond market have

been incredibly low. For example, 2008 was considered a record year for municipal bond defaults. Yet fewer than \$9 billion worth of municipal bonds defaulted. In the context of a \$3 trillion market, that represents a default rate of just 0.003%. Dire low-end estimate of \$50 billion in defaults would represent a 500% increase over 2008 default rates.

Defaults Are a Last Resort for Cities and States

While it's true that many states and municipalities are facing serious budget deficits, it is in their best interests to avoid defaulting on their debt at all costs. Why? Because defaulting on your debt makes it significantly more difficult--and more expensive--to issue new bonds in the future.

A report from the Center on Budget and Policy Priorities estimates that states and cities allocate just 4% to 5% of their budgets, on average, to interest payments on debt. With such a relatively small percentage of the total budget required to meet debt-related expenses, it makes no sense for legislators to deny the necessary appropriations and default.

As noted, most elected officials vehemently oppose the idea of filing for bankruptcy, fearing it could scare off investors and raise future borrowing costs. Cities and states realize the long-term costs of default will outweigh any short-term relief.

Unlike the federal government, cities and states must balance their budgets each year. Recent efforts in Wisconsin, Ohio, New Jersey, and other states demonstrate just how serious the challenges are. But they also provide hope for the future, as state legislators are finally getting serious about balancing both sides of their ledgers.

A balanced budget means the state has enough money to pay its bills and expenses, including debt service (payments to bond holders). Some observers view stories about dramatic budget cuts and tax increases as an indication of just how bad things have gotten. But if you are a bond investor, these are the types of actions you want to see.

Illinois and New Jersey are two states whose financial troubles were highlighted on the "60 Minutes" program. Yet recently, elected officials in these states have demonstrated a willingness to do what it takes to balance their budgets and right their financial ships. Among other measures taken, New Jersey pulled out of an expensive tunnel project because, as Governor Christie put it, the

state simply does not have the money.

Illinois raised income and corporate taxes by a significant amount and much of the press treated this as an indication of how bad things are in that state. Fair enough, especially for the taxpayers. However, even after a 66% increase in the income tax rate, Illinois still has one of the lower tax rates in that region. The individual tax rate went from 3% to 5%. If you are a lender to the municipality, and that is what municipal bond investors really are, you should view these actions as signs of fiscal responsibility and be comforted by the states' efforts to live within their means.

Under-Funded Pensions

Pension obligations are another looming challenge. As we saw in Wisconsin, heated discussions about controlling the escalating cost of public-employee pensions are raging in State Houses and local town halls across America.

The numbers are staggering when you hear how big the pension liabilities are, and that's without even considering the unfunded liabilities. However, a little perspective is necessary to understand why the pension issue is not an immediate threat. According to a report from Fitch Ratings, 2008's pension payments to retired employees totaled approximately \$175 billion. At the same time, the value of pension trusts totaled \$3.2 trillion dollars. We need to remember that pension money owed to retirees is not due all at once--it is spread out over many years.

To deal with the pension challenge, we are seeing the beginnings of reform take shape. Many public pension plans are discussing raising the retirement age and contribution amounts, as they acknowledge and address the hard economic and demographic facts. The mood seems to have changed somewhat as both pension administrators and participants realize that something needs to give if they want their pensions to remain solvent. We view this as an encouraging development for pensions and municipal bond holders.

The Economy and State Coffers Are Improving

The Great Recession caused steep declines in tax revenues that caught most city and state budget directors off guard. Yet as the recession fades further into the rear view mirror, municipal finances are showing signs of improvement. The economic picture is improving at the state level and this means more money is flowing into state coffers.

For example, according to the U.S. Census Bureau, tax receipts have increased in 42 states. Broken down further, state and local government's tax revenue increased 5.2% to \$284 billion in the third quarter of 2010, the most recent data available. This recovery in revenues is occurring at the same time that many state governments have reduced their spending.

Dislocation Creates Opportunity

Speculation about widespread municipal bankruptcy filings and hundreds of billions of dollars in defaults seems to have caused a near panic in the municipal bond market. It's really quite remarkable that a single person's views were able to move the market with such force.

Nevertheless, we believe municipal bond defaults and bankruptcies will remain rare and the asset class will continue to offer high quality, lower risk opportunities. And, as a result of the panic selling that has occurred in recent months, yields on some tax-exempt municipal bonds are now more attractive than the yields on taxable corporate and Treasury bonds. Income-oriented investors may want to take advantage of this scenario by considering high-quality municipal bonds.

About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,500 clients and over \$1 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is \$350,000.

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