

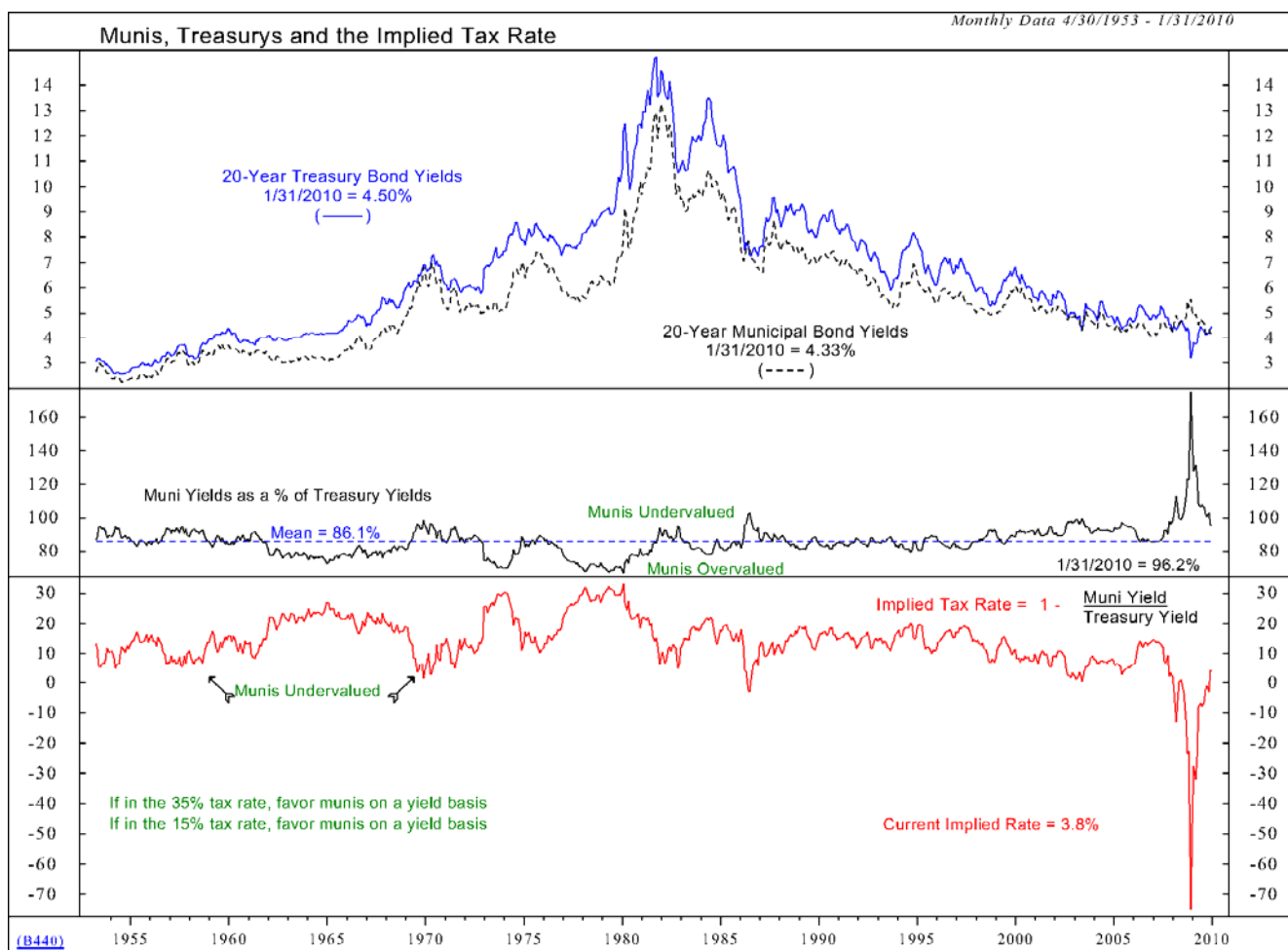
HOW SAFE ARE MUNICIPAL BONDS?

The QCI view on the state of the Tax-Exempt bond market

The Current Situation

Municipal bonds yields have declined significantly since the beginning of 2009. However, they remain above their historical average relative to Treasury yields (see Chart below.) We believe this is due in part to the continuing difficulties facing issuers of these bonds.

The budget challenges facing municipalities at all levels of government are arguably more severe than at any time in history. This is due to the combination of the sharp economic downturn and the aggressive expansion of many municipal budgets over the past several years. To be sure, not all municipalities are experiencing the same degree of stress. The problem has been exacerbated by difficulties with most municipal bond insurers, as their foray into insuring mortgage-backed securities has exposed them to losses in this market.



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The QCI Response-Part I

Early on in this downturn, we took measures to reduce credit risk in client portfolios. We reviewed every holding and identified those in which risk had increased to an unacceptable level. These were sold over the course of 2009, particularly as the municipal bond market began to recover and yields on these issues declined. What remain are issues whose credit fundamentals have been strong and are expected to remain so, and/or issues where debt service is provided by a highly secure source(s).

As an example of the latter, we can examine the structure of bonds issued by local school districts in New York State. School district general obligation (GO) bonds are supported and paid through the unlimited tax authority of the obligor district. Bond holders have a first claim on these tax revenues. In addition, we look for bonds that qualify for New York's State Aid Intercept program. Here, the state aid the obligor school district receives is also pledged against the principal and interest of the bonds. We feel quite secure having these multiple revenue streams backing the bonds.

Other structures which provide a highly secure source of repayment include:

- Defeased and Escrowed-to-Maturity issues, where debt service is covered via a portfolio of U.S. Government securities held in a trust created specifically for this purpose.

- Issues featuring U.S. Government securities as collateral, such as Federal Housing Administration insured mortgages.

- PIT (Personal Income Tax) bonds issued by certain agencies of New York State, which are backed by a first claim on state income tax receipts.

- Issues insured by municipal bond insurers that have remained financially sound through this difficult period, primarily because they avoided the mistakes of some of their competitors.

- Revenue bonds which are supported not by the revenues from a specific project, but rather by the general revenues of an institution, such as a sound educational institution(s.)

Where bonds lack the added security provided by their particular structure, we must feel comfortable with the commitment of the issuing municipality to stand behind its obligations. Most often, we have targeted issues supporting essential services such as water quality projects. Defaults on these types of bonds can have extremely negative effects on municipalities, when these services are interrupted.

The QCI Response-Part II

A cornerstone of QCI's investment philosophy is diversification. This can be seen in our approach to every investment category, be it equities, corporate bonds, or municipal bonds. As the economic downturn has persisted, it has become clear the economic stresses are much greater in certain areas. This being the case, we have taken steps to diversify our clients' holdings even further. For those living in low/no income tax states, we have begun a systematic program to diversify their holdings across a wider variety of states. Purchases will be restricted to those states where financial discipline has been exercised, and where the economic downturn has been the least severe. Sales will obviously concentrate on issues in states where this has not been the case.

Where clients live in higher-tax states, such as New York, we have taken a first step toward diversifying into other states. We are currently analyzing the situation to determine whether additional moves are prudent.

As with all our investment work, this is an ongoing process. Our client holdings are reviewed monthly for deterioration in price/yield. In addition, we are constantly monitoring the municipal landscape to identify problems early and take action if necessary. One such development is the recent talk of a specific municipality, Harrisburg, PA, using Chapter 9 bankruptcy to restructure its obligations to both employees and bondholders. Some are claiming this is a harbinger of things to come, as more issuers resort to this measure. Our view is different. The few times this approach been utilized, it has been to address a problem specific to the municipality in question. This is the case with Harrisburg today, where the problems predate the current economic downturn. Those predicting an outbreak of Chapter 9 filings have little or no evidence to support such claims. This is not to say their arguments are completely without merit, but we need to see something beyond conjecture before we could support such a dire outlook.

We expect more concerns to be raised as we work through this difficult period. QCI will continue to analyze the municipal bond environment, and will not hesitate to take actions deemed necessary to protect client portfolios. As always, we invite your questions and stand ready to address your concerns in this and any other area of your portfolio.

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