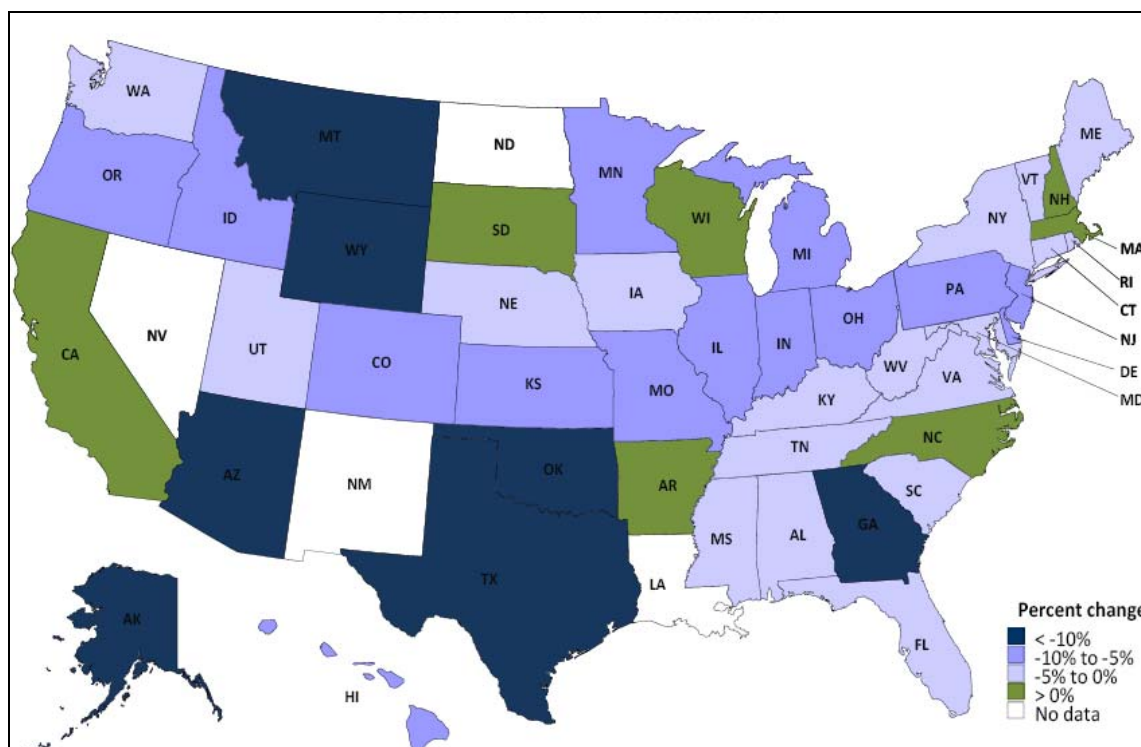


## *Municipal Securities Question and Answer*



**State Tax Revenue Declines October 2008 – December 2009<sup>i</sup>**

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**Recent headlines raise issue with municipalities' ability to manage their finances.**

“I don't think Moody's or Standard & Poor's or I can come up with anything terribly insightful about the question of state and municipal finance five or ten years from now, except for the fact that there will be a terrible problem and then the question becomes will the federal government help.” – Warren Buffett<sup>ii</sup>

“What are the real risks of holding municipal bonds when states and municipalities are struggling to pay their bills?” – The New York Times<sup>iii</sup>

“There is no question that the recent dislocations in the municipal bond markets have created unanticipated hardships for municipal issuers and, in some cases, dramatically increased their borrowing costs.” “In addition, issuers of municipal securities have in recent years greatly increased their use of sophisticated financing arrangements, interest rate swap agreements and other derivative financial products in connection with municipal securities offerings. The widespread use of complex products by municipal issuers raises concerns about risks to investors, markets, and taxpayers.” – U.S. Securities and Exchange Commission<sup>iv</sup>

**News articles and quotes similar to the ones above have raised the level of concern CapTrust has for the ownership of municipal securities within a portfolio. In order to provide our clients with a better understanding of the municipal market, CapTrust has prepared this Question and Answer guide. The following is a review of questions regarding municipal securities answered by the 11-person internal Investment Research Committee at CapTrust.**

**General Background on the Municipal Bond Market**

**Q.** How big is the U.S. municipal bond industry?

**A.** As of December 31, 2009, the Federal Reserve estimated the municipal bond market accounted for more than \$2.8 trillion in issued securities.<sup>v</sup> During 2009, more than \$487 billion in new bonds were issued to support local and state municipal funding needs. In the U.S. there are more than 50,000 state and local issuers of municipal securities accounting for two million separate outstanding bonds. Despite the municipal market's reputation as a "buy and hold" market, trading volume within municipals is substantial with over \$6 trillion of long- and short-term municipal securities traded each year.

**Q.** Who are the issuers of municipal bonds?

**A.** A municipal bond is a bond issued by a state, city, special district or governmental agency. Potential issuers of municipal bonds include cities, counties, redevelopment agencies, special-purpose districts, school districts, public utility districts, publicly-owned airports and seaports, and any other governmental entity below the state level. Municipal bonds may be general obligations of the issuer or secured by specified revenues.

**Q.** What are the most common types of municipal bonds?

**A.** **General Obligation** bonds are a common type of municipal bond secured by a state or local government's pledge to use tax or fee revenue to repay bond holders.

**Revenue Bonds** are payable from a specific source of revenue collected from an entity associated with the purpose of the bonds. Issuers of revenue bonds often support financial projects for water and wastewater plants, toll roads and bridges, airports and other transportation-related hubs, power plants and electrical generation facilities.

**Industrial Development Bonds** are public financing of private business which boost the local economy. An example of an industrial bond issue would be a local manufacturer issuing bonds through a municipality to build a manufacturing plant that would employ individuals in the surrounding community.

### Rating Agencies and Bond Insurance

**Q.** Why are bonds rated?

**A.** Bonds are generally rated for a fee to reduce borrowing cost and generate greater interest in the bond when sold to the market.

**Q.** Who are the agencies rating bonds?

**A.** Standard & Poor's, Moody's, and Fitch dominate the rating of municipal bonds.

**Q.** How does a municipal bond become insured?

**A.** Bond insurance is backed by a financial services company or bank and is generally used to provide credit enhancement to the underlying issue. Municipalities can raise their credit ratings and lower their borrowing cost by paying for bond insurance. Unfortunately, a number of municipal bond insurers have been plagued with financial issues over the past few years and their ability pay on their bond insurance has come into question. One of the largest municipal bond insurers, American Municipal Bond Assurance Corporation (AMBAC) announced in June of 2010 that they may file for bankruptcy. If AMBAC were to enter into bankruptcy it would surely impact the credit rating of any municipal security issued with AMBAC insurance. The insurance market for municipals is fairly substantial with estimates that, as of 2007, 50-60% of all municipal bonds were covered by some form of bond insurance.<sup>vi</sup>

**Q.** Are there risks related to those institutions underwriting this insurance?

**A.** Recently a number of municipal insurers have been downgraded in quality due to their exposure to the sub-prime mortgage market. AMBAC, the second largest insurer of municipal bonds, is floating the notion they may file for bankruptcy protection in the coming months. AMBAC experienced a significant deterioration in their credit quality as a result of the sub-prime market meltdown. If AMBAC were to file for bankruptcy protection it would subject a number of insured bonds to a possible downgrade in quality.

### Traditional Ways to Invest in Municipal Bonds

**Q.** What are some of the concerns with the products available to invest in the municipal markets?

**A.** There are many ways to purchase and own municipal bonds. However, each method of purchase needs to be thoroughly understood to help identify some of the risk in the purchase.

**Broker-Assisted Transactions** are one way to invest in municipal bonds. However, this method may lack in a number of ways. Brokers may not have a specialized understanding the risks involved in the securities selected.

When selecting securities, Brokers may have performed little to no credit research of the underlying securities. Incentives for Broker-assisted transactions are often driven by sales fees and not overall performance. Additionally, single purchases of a stand-alone municipal bond may not provide appropriate diversification.

**Passive Closed End Funds, Open End Funds and ETF's** are three products for investing in municipal bonds. Passive funds have one central issue; they are not actively managed to avoid risk. With a passive fund, the investment mix is often built on an initial risk profile for the fund or an index. Building funds based on a risk profile can be faulted when markets go to extremes, as seen in 2008 and 2009. The perceived benefit of an actively managed portfolio over a passive portfolio is an active portfolio is expected to respond to changes in the market. Unfortunately, passive funds are often created to serve as a product offering to funnel assets into and not as a fund which adjusts to market movements to maximize the risk to return characteristics.

**Active Closed/Open End Funds** are actively managed funds which position portfolio for maturity, duration and call features. Funds may not be managed to deal with potential problems as they occur and can suffer from deteriorating credits. The funds are constructed to offer a product for investors and vary in the level of active management following their creation.

**Separately Managed Accounts** involve hiring professional investment managers who specialize in managing portfolios of municipal bonds. These types of accounts have the benefit of active management with continuous monitoring. Managers can be more selective in picking bonds for the portfolio. With separately managed accounts, credit analysis should be ongoing and the portfolio ought to be supported by an investment team with accountability for the product.

### Historical and Current Risks in the Municipal Bond Market

**Q.** What are some statistics on historical bond default rates?

**A.** Historical default rates for municipal bonds have been significantly lower than corporate bonds. In a study published by Moody's on municipal bond defaults, it was noted from 1970 - 2002 municipal bonds had a cumulative default rate of 0.0043% on an annual basis compared with a 0.675% default rate for Aaa-rated corporate bonds. The Moody's study found not-for-profit healthcare bonds had the highest level of default from 1970 - 2002, accounting for nearly 50% of defaults.<sup>vii</sup> Additionally, Fitch published a research report in 2002 where they studied 2,339 municipal defaults occurring from 1980 - 2002. In this report, it was noted in municipal bond defaults the average investor recovered 68% of their investment; where as with corporate bond defaults investors typically recovered only 40% of their dollar investments during the same period.<sup>viii</sup> The recovery rate after default for municipalities is substantially higher because, unlike corporations, municipalities do not fail to exist after a bankruptcy filing. Ultimately, municipalities must exist to serve their constituents.

**Q.** What are some recent issues in the municipal market?

**A.** The **City of Vallejo, California** filed for Chapter 9 bankruptcy on May 23, 2008. The city claimed a few distinct issues resulted in the default on their municipal bonds. First, the city claimed they experienced a decrease in revenue from property taxes and sales taxes. Second, the city incurred \$3.4 million in unbudgeted pension costs. Finally, cuts of state-level funding the city had budgeted for took away additional revenue that would have helped pay for bond servicing. The Chapter 9 bankruptcy resulted in court arbitration where a few concessions were made to help keep the city on budget. The concessions included capping some of the floating rate bonds issued by the city at an interest rate at 6%. In addition, the police union agreed to decrease staffing saving \$6 million in operating cost. Also, the professional workers union reached a settlement to reduce pension and healthcare benefits which further saved the city money.<sup>ix</sup>

**Jefferson County, Alabama** experienced significant financial strain during 2007 and nearly went into bankruptcy due to derivative contracts from a sewer project. Jefferson County sued J.P. Morgan alleging malfeasance in the issuance and structure of over \$2 billion in derivative contracts. In 2009, J.P. Morgan settled with Jefferson County after facing charges from the U.S. Securities and Exchange Commission (SEC) regarding the sewer system derivatives. According to the settlement, J.P. Morgan will be required to forfeit more than \$647 million in claimed swap termination costs and fees related to the Jefferson County sewer system. Additionally, J.P. Morgan will pay a penalty of \$25 million to the SEC along with a \$50 million payment to Jefferson County.<sup>x</sup>

**Q.** How many states have authorized municipalities to seek Chapter 9 bankruptcy?

**A.** Currently, twenty-four states have authorized their municipalities to seek protection under the Chapter 9 bankruptcy code. A common misconception under a Chapter 9 filing by a municipality is general obligation debt holders have a right to receive ongoing interest payments. However, there is a risk these payments could stop during Chapter 9 proceedings.

**Q.** How has the current economic environment impacted municipalities?

**A.** Like any company, cities and states are run with varying degrees of financial soundness. Just like a company, state and local municipalities must plan accordingly to a revenue and expense schedule. In light of the recent downturn in the economy, many states and municipalities are experiencing financial hardship.

State revenues are collected from approximately 40% income tax and 33% sales tax<sup>xi</sup>. According to a report by Barclays Capital, states collected about \$79 billion less in sales, income and corporate tax during 2009 than in 2008. The loss of \$79 billion in tax revenues would have been worse had 33 states not passed tax measures which ultimately generated \$31.7 billion in additional tax revenue for 2009.<sup>xii</sup>

Moody's estimates property taxes account for an average 72% of local government revenue. It is no secret property values have declined over the past three years. Although many of the properties have not been re-valued in terms of the municipality adjusting the tax levied against the property, we would estimate going into the economic downturn most local municipalities budgeted for long-term revenue growth from property tax and not a sharp decline.

State and local municipalities have entered into contractual obligations to fund pension and health benefits to government workers. When benefits are underfunded, municipalities must take the shortfall from their operating budgets to make up the difference. The amount a government entity contributes to the pension from their operating budget is typically related to the funding level of the plan. With the recent downturn in the market, funding levels have been dropping and states have had to make larger contributions to make up the funding differences.

There is speculation municipalities would seek Chapter 9 filings in an effort to renegotiate employee benefits through a court process, rather than the tougher political approach of eliminating staff, fighting unions for benefit reductions, or increasing service fees and taxes on constituents.

**Q.** Are derivative contracts employed in the municipal bond market?

**A.** Municipalities often use swap contracts to lower borrowing costs or change the payment characteristics on their debt. Swap contracts are financial contracts that allow the borrower to change the terms of their debt. For example, a swap contract can be used to change a fixed rate bond payment into a variable rate bond payment.

Municipalities may enter into a swap agreement to capture current income, which is refunded to them by counter parties or an investment bank.

**Q.** Are municipal bonds registered with the SEC?

**A.** The SEC requires all bonds being offered to the investing public in the United States be registered; however, U.S. government, federal agency and municipal bonds are exempt from this rule.<sup>xiii</sup> Although, with the recent Dodd-Frank Financial Regulatory Reform Bill, some provisions were added which have increased the SEC's jurisdiction over municipal securities.

### **Municipalities Being Proactive**

**Q.** What can states and municipalities do to shore up their budgets?

**A.** Municipalities have taken some aggressive measures recently to shore up their budgets.

**California** – Hoping to raise \$2 billion in revenues, California is using the real-estate advisory group C.B. Richard Ellis to auction off 20-year leases on 11 government-owned properties. The properties are being packaged for sale as the Golden State Portfolio and include assets such as the San Francisco Civic Center, along with the Attorney General and Department of Justice buildings in Sacramento.

**Arizona** – In January of this year, Arizona completed a \$735 million dollar, 20-year sale-leaseback transaction. The assets sold include legislative buildings, the Department of Public Safety headquarters, various state prison facilities and other assets of the state. In light of the success of the program, Arizona is working on raising an additional \$300 million in a second round of asset sales this summer.

**Hawaii** – In an effort to keep from laying off teachers, the state instituted a four-day school week beginning in October 2009.

**Q.** What short-term and long-term tools are available to states and municipalities for managing their budgets?

**A.** States have some tools to manage their budgets. States can initiate spending cuts to meet budget shortfalls and institute tax and revenue increases. A number of municipalities already have in place restricted contracting initiatives, where contracts are awarded to neighborhood vendors in order to support the local economy. To really get at the issue, states and municipalities could reduce or eliminate services to citizens or benefits to employees.

Longer-term, by implementing “pay as you go” programs, implementing benefit caps equivalent to the private sector and cutting back on frivolous services could shore up the liabilities of many municipalities. Ultimately restructuring the financial liabilities of the municipality or reducing the benefits paid should lead to longer-term stability within the municipal market.

**Q.** What are some of the states that have more apparent credit risk?

**A.** The Center on Budget and Policy Priorities anticipates the deficiencies reported below for 2010 and estimates budget shortfalls will continue into 2011. We believe increased caution should be exercised when holding municipal paper in these states.

Total FY2010 Budget Gaps <sup>xiv</sup>		
	FY2010 Total Estimated Budget Gap	FY2011 Total Estimated Budget Gap
Arizona	\$5.1 billion	\$3.1 billion
California	\$45.5 billion	\$17.9 billion
Florida	\$6 billion	\$4.7 billion
Georgia	\$4.5 billion	\$4.2 billion
Illinois	\$14.3 billion	\$13.5 billion
Michigan	\$3.3 billion	\$2 billion
Nevada	\$1.5 billion	\$1.8 billion
New Jersey	\$11 billion	\$10 billion

## Conclusion

There is little doubt investors who own municipal bonds do so primarily for the tax-free income, as well as the relative safety of their principal. While investors who are allocated to equities accept the price volatility derived from unforeseen events, it is likely municipal bond owners do not expect the same type of price fluctuations. The above Question and Answer guide was constructed to help provide information regarding municipal bonds. While it would be difficult, if not impossible, to predict a crisis in the municipal bond market, understanding where a crisis could come from might be useful to weathering the storm.

Here are some additional questions CapTrust has posed to the institutional managers who oversee municipal bond portfolios on our clients' behalf. We encourage you to ask these same questions of the investment managers who oversee your municipal bond portfolio as well.

1. What information do you receive and review in order to understand the economic and financial condition of a municipal issuer?
2. What is the experience of your personnel with respect to the specific types of municipal issues held and managed by you?
3. Does your personnel have any firsthand knowledge of the locale and/or how the "industry" works?
4. What systems does your firm have in place to monitor the financial filings of a municipality under SEC Rule 15c2-12?
5. Is there a committee, department, or an individual who reviews the financial information published by municipalities under SEC Rule 15c2-12?
6. What is the process for the implementation of a sell order or a workout in the event of the receipt of negative information?
7. Are written reports prepared describing any findings or conclusions derived from the financial information?
8. What efforts are made by your firm to determine whether there are swaps associated with the municipal issuers?
9. Does your firm analyze the effects of the swap upon the municipal issues with which it is associated?

## **Important Disclosures**

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