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INVESTMENT UPDATE

After taking on the financial plight of Europe in last month's *Investment Update*, this month we'll turn our binoculars around on...us. More specifically, the health of state and local government finances. We'll focus our closest attention on the states of California and Illinois, the Poster Boys for states with financial troubles.

We have a special interest in this topic because it, even more than the Eurozone's finances, has a direct bearing on the US bond market. State and local governments (and their financial agencies) have long been issuers of tax-free municipal bonds, which don't really concern us, as our clients are almost exclusively nontaxable entities, and as such have little use for low-yielding tax-free bonds. But issuance of new *taxable* municipal bonds exploded in 2009-10 in the form of "Build America Bonds" (BABs), a new class of taxable munis that were part of the 2009 Economic Recovery Act. According to the US Treasury, there were more than 2,200 separate BABs issued between the program's inception in April 2009 and its expiration at year-end 2010, totaling more than \$181 billion. Issuers included, according to the Treasury, "state and local governments in all 50 states, the District of Columbia, and two territories."

Practically overnight, a new class of bonds was invented and introduced into our universe of investment grade, dollar-denominated bonds. Currently, the Barclays Aggregate Index (the standard "core bond" benchmark) shows BABs with a market value of approximately \$155 billion, made up of 269 separate bonds issued by states, local governments, and their affiliated agencies (please don't ask why Barclays has chosen to categorize BABs as "foreign local government" bonds, we haven't a clue). While BABs represent only about 1% of the Aggregate Index, they cannot be ignored, and in fact are highly significant for clients interested in long duration portfolios, where they represent 13% of the Long Credit Index.

Our job is to seek out the "best" bonds for our clients' portfolios; we're looking for bonds with superior return prospects, subject to our rigorous analytical processes. We want bonds with good, solid yields, high quality, ample liquidity, and clean structures (no crazy embedded optionality or opaque indenture provisions). Bonds issued by entities that we can get to know, and whose operations and businesses we can understand. We are, for all intents and purposes, lending our clients' funds to these bond issuers, after all, and it's essential that we have timely and accurate information from these issuers so that we have a high degree of confidence that they'll be good enough for our clients' portfolios over the long haul.

And this is where things get sticky.

As it turns out, public entities are not subject to the same rigor-

ous standards that private companies must adhere to when they issue debt. When a company issues a corporate bond, it must file up-to-date financial statements that disclose, in detail, the financial condition of the issuer, the purpose of the bonds, the risks associated with buying these bonds, and what happens to the bondholder if something goes wrong. While the corporate bond market is highly regulated by the SEC and other entities, the municipal bond market (including BABs) is largely self-regulated, with the SEC having more of an oversight role (although the SEC is trying to change this). As a result, the financial data that's released by municipal bond issuers is remarkably poor.

In fact, a 2010 study by municipal finance specialist firm DPC DATA described a large and growing problem. Between 2005 and 2009, more than 56% of muni issuers filed no financial statements in one or more years. More than one-third skipped three or more years. In 2009, that number grew to 40%, with an additional 30% filing "extraordinarily late." Further, the statements that were filed were often incomplete or insufficiently detailed for the purposes of in-depth credit analysis.

What's more, the very nature of the revenue source makes municipal bonds far more difficult to analyze than a typical corporate bond. Corporate bonds, at least in the high-grade markets in which we participate, are issued by companies with well-known and predictable businesses (no, Facebook hasn't issued investment-grade bonds!), with a known customer base, and a management team that's accountable for the profitability of the business and which often has a direct stake in the health of the business. Of course, there are risks, and events and business conditions can negatively impact a company's profitability, but typically these risks are out in the open and can be analyzed and quantified by competent credit analysts. Financial projections can be made about the company's prospects, with a fairly high degree of confidence.

But when we look at municipal issuers, it's a completely different kettle of fish. The source of income that will be used to repay the bond holders comes not from a base of customers, buying the company's goods or services; in the muni world the money comes from taxes or, in the case of revenue bonds, from tolls, user fees, tuition, or other revenue sources. These revenues can be unpredictable, and are often shared with other agencies affiliated with the bond issuer. With general obligation bonds (those tied to the general taxing power of the state or local government who issued the bonds) there is a presumption that the local government can simply raise taxes in the event that tax receipts fall short; while technically true, there are often institutional or practical impediments to "simply raising taxes," especially in the current partisan climate.

As an example, a tax hike in California requires either voter approval or a two-thirds majority among legislators. And for revenue bonds, the reliability of the revenue stream is even more suspect. For instance, a new toll road can cost hundreds of millions more than expected to build, and generate less revenue than projected; in many cases the revenues from a toll road are put into a general highway fund, and appropriations are made from this fund (as well as other sources) in a way that is unrelated to the toll road itself. In short, revenues related to municipal bond projects are far less “transparent” when compared to the revenues generated by a typical corporation.

So, it’s difficult to get good financial data on many of these municipal issuers, and even with good data, the lack of a direct linkage between the income of the issuer and the bondholder makes many municipal deals somewhat sketchy. But there’s one more consideration that, especially when compared to yields on corporate bonds, all but kills our interest in BABs: The shaky financial conditions of many state and local governments.

For the purposes of the present discussion, we will table the issue of local government finance. The high-profile default of Harrisburg, Pennsylvania’s general obligation bonds in March was a rare occurrence, but there are hundreds more potential defaults looming on all manner of revenue bonds issued by local governments and agencies. Most of these are smaller bond issues related to local projects and “economic development” schemes gone awry. These should worry individual investors who’ve been sold tax-free muni bonds or hold them in shares of mutual funds, but in our world (the taxable bond market) we are much more concerned about the fate of the larger BABs issuers—the states and their agencies.

Despite the well-known and well-publicized weakness among most state treasuries, 48 out of the 50 states still have a credit rating of “AA” or higher. The two that are rated single-A, California and Illinois, also happen to be the biggest issuers of BABs, with \$20 and \$16 billion outstanding, respectively (those figures do not include state agency bonds, just BABs issued by the state treasurers). There are many other large BAB issuers, including the New Jersey Turnpike and New Jersey Economic Development agencies, the University of California system, the New York City and Chicago Transit Authorities, and dozens of others, all multi-billion dollar issuers of BABs. But California and Illinois are special cases, due to the size of their budget deficits and their potential impact on institutional investors. But that’s where their similarities end, as we shall see.

The problem in California (whose GDP represents 13% of the US economy) is not that they haven’t been willing to make tough decisions; the state has made massive spending cuts in the past few years in an attempt to balance their budget: California’s spending in fiscal year 2012 is 5.1% of the state’s income, its lowest level in any year since 1973! But revenue has dropped even more, to 4.8% of income. The recession has hit California as it has all states, by reducing income tax revenues. But California has been further hampered by an inflexible tax structure, which relies too heavily on personal income taxes. Sales and use taxes in California apply only to tangible consumer goods;

California’s service- and technology-heavy industries have been growing at the expense of manufacturing, shrinking that portion of the state’s revenues.

The increasing reliance on personal income taxes has meant that California’s revenue stream has become much more volatile, and far more dependent on higher earners. S&P estimates that California’s top 1% of taxpayers account for 11% of general fund revenues, up from less than 3% in 1979. Meanwhile, sales and use taxes are expected to make up only 22% of general fund revenues, down from 38% in 1979. Likewise, the windfall in capital gains taxes during the dot-com boom has evaporated; between 2000 and 2010, capital gains fell from 15% to 3% of general revenues. The result is that the governor has few choices, in the short term, other than to get voters to agree to raise rates on both income and sales and use taxes, while he works with the legislature to make additional spending cuts where possible.

Like California, Illinois’ state constitution requires a balanced budget, but that hasn’t happened in more than a decade. Unlike California, Illinois’ problems are centered on the poorly-funded status of their five state pension funds which, in total, are underfunded by \$83 billion. Due to the failure of the legislature to allocate necessary funding to the pension funds over the past few years, these plans are currently funded at only 43%, a shockingly low figure. Using GASB accounting standards, it is estimated that it would take contributions of \$8.7 billion per year, approximately 29% of 2013’s general fund appropriation, to bring funding to 100% in 30 years.

The other main difference between Illinois and California is that Illinois has been much more successful at raising taxes than cutting costs. Obviously, going forward, both will be necessary. Unfortunately, efforts to cut Illinois’ generous pension and retirement benefits, a vital step, will not be easy; courts have looked unfavorably on states’ attempts to do so. Instead, the governor is attempting a “cram down” for current employees, threatening to cut healthcare benefits if they refuse to accept changes to the pension plan. It will be a difficult fight given the strength of Illinois’ public employees unions, but it is a step that will be necessary to keep the state solvent.

It will come as no surprise that our portfolios are BAB-free. There are just too many negatives with these credits given their relatively low yields compared to corporates. The fact that the ratings agencies endow a “AA” or “AAA” rating on so many of these state government bonds gives us no comfort; California and Illinois are in no way unique, as essentially every public pension fund, state or local, has large unfunded liabilities.

As always, our markets are subject to change. If real financial reforms are enacted at the state and local level, if significant progress is made in the regulation and financial reporting for municipal issuers and if yield comparisons become more favorable relative to corporate bonds, we would consider these bonds for our clients’ portfolios. But in this environment, and at these yield levels, we are more than comfortable with a significant underweight in BABs.