Muni Headline "Noise"

The spotlight of the press is now on state and local governments, which is an often ignored, but very important part of our economic system. This sector accounts for 13% of GDP and 15% of the jobs in the U.S. Most municipalities are currently facing some level of financial stress as the recent economic downturn has led to a drop in tax revenues, while the demand for services has remained high. At the same time, past pension and healthcare benefit promises made by policy makers to public employee unions appear to be unrealistic. Many of these benefits are not fully funded and ongoing negotiations will continue in an attempt to scale down these liabilities. As municipalities grapple with these politically charged issues, investors will continue to witness bad "noise" in the headlines. It is important for investors to understand the process of balancing budgets is "noisy" as programs get cut and employee headcount is reduced in order to eliminate deficit spending. We believe the recent attention brought to these issues is a positive development. The increased awareness of budgetary imbalances and the need to address them will allow policy makers to make budgetary progress in the future. Citizens across the country will discover these problems are not unique to their state, and the need for austerity has finally arrived.

However, we believe the bold predictions of a widespread Muni meltdown resulting in "hundreds of billions of dollars in Muni defaults during the next 12 months" are completely unfounded. These dire predictions have come from analysts that have little or no experience with Muni finance. The table below shows the boldness of this prediction. Muni defaults have actually been declining since 2008 during this period of fiscal stress and were about $2.5 billion in 2010.

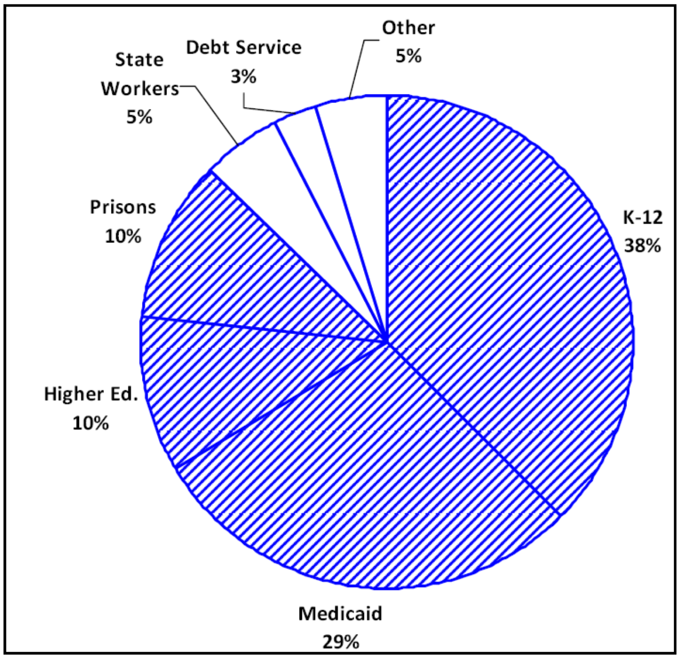
Volume of Muni Defaults In $Billions

Year	2010	2009	2008	2007
Defaults	2.48	7.28	8.15	0.348

Generalizations about muni credits are difficult, because Munis are a fragmented market with over 50,000 different issuers. Each of these bond issues has it's own set of bond covenants which are designed to protect the bondholder. Muni bonds carry varying degrees of credit risk. Risk levels depend upon the public purpose of the financing and the options available to bondholders and issuers if current economic assumptions are not met. A good Muni analyst is like a loan officer. He or she seeks out securities with good legal protections, and adequate debt service coverage to make sure of *the return on principal, and the return of principal* at the agreed upon time. The security of a loan depends upon the ability and willingness of the borrower to service the loan.

Muni Budgets

Muni finances and Corporate finances are very different. When a corporation experiences extreme stress it is usually a liquidity problem because it is over-leveraged and is not able to roll over it's debt. Bankruptcy is the mechanism to deal with this problem, and allows the corporation to create a plan of reorganization. This plan typically results in bondholders receiving less than what they were originally entitled. Sometimes corporations cease to exist and creditors split the remaining assets of the corporation. Most municipalities are not over-leveraged as debt service is typically only 3%-12% of their budget. Financial stress for a city or state occurs during economic downturns, because of a decline in tax revenues. A municipality is an ongoing entity. Dissolution is not an option. Bankruptcy, if allowed, doesn't make debt obligations go away, it just postpones their payment. Let's look at Arizona as an example. The State of Arizona has a projected budget deficit of $530 million in 2011 and $975 million in 2012. The chart below is from a 1/14/2011 budget report by the Joint Legislative Budget Committee for the State of Arizona. The chart shows 87% of the budget is for education, corrections, and healthcare. Only 3% of the budget is for



debt service. Lawmakers have the difficult task of deciding how to fund this deficit? So, what are their options? They could raise taxes, or cut expenses. Defaulting on their existing obligations is the most undesirable option. It doesn't remove the obligation and only adds to the cost by incurring additional interest costs. Debt Service is also only $271 million or 3% of the total budget and is not a large enough category to solve the shortfall anyway. A debt default would cause the state to lose it's liquidity and ability to borrow, thus reducing it's financial flexibility significantly. It is a disastrous and only temporary solution to a difficult problem. There is no good reason for the state to default on it's bonds.

Muni Bond Defaults

The table below contains data from a recent Municipal Market Advisors (MMA) Weekly Outlook dated 1/10/2011 regarding existing Muni bonds in default. MMA is an independent research firm and is not associated with any of the rating agencies. It shows some Muni sectors are more risky than others, and non-rated bonds are riskier than rated bonds. In fact, 84% of the Muni issues currently in default were non-rated at the time of issuance. It is also clear that a very small number of bonds in default are in Safe Sectors, such as general obligation, water and sewer, and sales tax revenue bonds.

Existing Muni Bond Issues In Default		
Sector	Amount in Billions	Number of Issues
Safe Sector (GO, Wtr/Swr, Sales Tx)	.048	4
Land Secured	2.272	117
Toll Road/Transit	1.488	3
Tribal	1.385	6
Housing	.731	46
Retirement	.695	27
Hotel	.338	5
Hospital	.273	6
Other Risky Sectors	.878	42
Total	8.108	256
Source: Muni Market Advisors Weekly Outlook 1/10/2011		
Initially Non-Rated		
	5.018	215
Percent of Total Defaults	62%	**84%**

Safe Sector Investing

We believe that individual security selection is extremely important, and is the best way for investors to reduce credit risk in the Muni market. Our security selection process begins by examining the public purpose of the bonds. We concentrate on issues which we deem to have a good public purpose so that if things go wrong there will still be support for the project financing. We only buy bonds which are A-rated or above. We believe non-rated bonds are too risky. Next, we are primarily a safe-sector investor. This means our portfolios consist primarily of general obligation, essential service revenue, or sales tax revenue bonds. Within the G.O. category, we prefer school district bonds, because of the strong public purpose, and historically low default rates. Even during the Great Depression, school district bonds had a very low default rate. Most of these bonds are secured by property taxes which is a less volatile source of revenue than income taxes or sales taxes. These taxes are paid to the county treasurer who then holds them in a segregated account for payment of debt service to the trustee or paying agent for the bonds. Many school district bonds have state programs which additionally secure the bonds. Preference is given to bonds with low debt per capita, and low debt to assessed valuation. We typically avoid bonds for big cities and states because of the potential for unfunded pension and healthcare liabilities, and bad headline news. We also give preference to high net worth areas or Munis with high per capita income levels and low amounts of debt. We like essential service revenue bonds because these issues have a monopoly and provide a necessary service such as water, sewer, and electric. It is also relatively easy to follow debt service coverage on them. Finally, we like sales tax revenue bonds. Frequently these bonds are secured by a first claim on the sales tax revenues of a municipality. Many of these bonds are issued by cities that depend on the excess sales tax revenues which go into the general fund, as a primary source of general fund revenues. So, there is an incentive for the municipality to make sure the bonds do well. Many of these bonds have 4 to 20 times debt service coverage. We generally avoid bonds in the other sectors, but occasionally we may make an exception for a particular security with a strong track record and good risk/reward characteristics.

Conclusion

Investors should be wary of bold, and dire predictions made by pundits with little or no experience analyzing Muni credits, who make sweeping generalizations about a market they know little about. This is especially true when these predictions are based upon projections of budgetary stress without understanding how the process works and the likelihood of an actual default. Instead, they need to make sure they have a sound investment credit strategy in place for their fixed income investments. This strategy should recognize that all Muni bonds are not created equal, and security selection is extremely important. Since there are over 50,000 different Muni issues, there are plenty of options for investors when choosing securities. Because improper security selection may be penalized severely in the future, care should be taken to have a well disciplined, and thoroughly researched security selection process. Bond investors would be wise to avoid non-rated bonds, because most Muni defaults (84%) occur in issues that are non-rated when they initially come to market. Bonds in sectors that are heavily dependent on the economy should also be avoided, because they have a higher probability of default than safe sector bonds. Most of these riskier bonds have limited options available if economic assumptions are not realized. We believe our strategy of investing in safe sector bonds is a sound strategy which has done well in the past, and will continue to do well in the future.