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The Municipal Credit Landscape

Several high profile stories and prognostications about looming financial disaster for state and local governments have permeated the headlines in recent months. We firmly believe that the degree of hype generated by the news media has been inflated, driven by its charge to create editorial headlines, and that default risk is isolated and marginal. We are pleased to offer our insight:

Summary of the Issue

State and local budgets are stressed nationwide and the need to reduce deficits is very real. While states like California, Illinois and New Jersey often make the headlines, revenue and cost challenges are not isolated to these three states. State and Local governments derive revenue from 3 main sources: 1) Property taxes 2) sales taxes and 3) income taxes. All three sources have been severely impacted by the financial downturn. Real estate prices are down, consumer spending has been weak, and unemployment remains high. While federal stimulus dollars have helped address revenue shortfalls through 2010, the evolving political landscape makes further federal support less likely. Further significant expenditure cuts must be considered.

State and local governments also face longer term structural challenges, most notably sizable pension and health care obligations promised to municipal employees. Many of these promises were made during healthier fiscal times, but have not been adjusted to reflect the realities of the current fiscal landscape.

Given the current backdrop and outlook, it is reasonable to suggest that some state and local governments will not be able to meet all of their future obligations. Where the message often breaks down, however, is how this might affect bondholders and what this might mean for the tax-exempt market.

Caprin's Perspective

The municipal fiscal challenge is nothing new. Problems are widespread and in many cases severe. However, a few considerations are in order:

- **This is not a new story** – Municipalities began to experience strained finances with the onset of the 2008-2009 financial crisis as housing prices began to fall, consumer spending waned, and unemployment began to rise. Caprin has aggressively managed this risk through the cycle. Over the past two years, Caprin's National strategy has sought to avoid states that would be particularly vulnerable to the housing-driven slowdown. While this meant leaving some yield on the table, we maintained pessimism over the financial outlook for states that had gorged on revenue generated during the housing boom. Within state specific strategies, Caprin has focused on higher quality bonds to enhance stability and liquidity, particularly for bonds with longer maturities (10-15 years). Across strategies, Caprin has been proactive in positioning portfolios according to this fiscal outlook.
- **Issuer matters** - There are distinctions to be made between municipalities. Many state and local governments entered this downturn with budget surpluses and sizable reserves and are much better positioned than others to endure a multi-year slowdown. Some are managing through the current environment, making tough decisions, cutting costs, raising revenues and addressing longer term structural concerns. Others are kicking the political can down the road, perhaps holding out for federal assistance or hoping to grow their way out of their problems. At Caprin, we have maintained a strong bias against higher risk, financially struggling municipalities that have not demonstrated a history of prudent fiscal management. We remain steadfast in evaluating credits on an individual basis. Specific examples of the wide variations in pension situations taken from a Fitch Report dated December 15, 2010, include North Carolina's Teachers' and State Employees' Retirement System, which was funded at 95.9% as of Dec. 31, 2009, down from 104.9% two years earlier

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due to market losses, but nonetheless very well funded. The state and other member governments have a demonstrated commitment to fully funding their ARC. In stark contrast, the State of Illinois' five retirement systems combined had a funded ratio of 50.6% as of June 30, 2009, down from 63.6% two years earlier.

- **Structure matters** – The nature of an obligation varies from bond to bond. General Obligation bonds carry certain legal protections for bondholders in terms of priorities of cash flows. Also, some types of revenue bonds may be lower risk than others given the essential nature of the projects financed. For example, the bonds supporting a water system may be less vulnerable to restructuring and/or default than bonds supporting a parking deck or a performing arts center. Caprin has maintained a bias for General Obligation and essential purpose revenue bonds
- **Default is a drastic, unattractive option for issuers that would likely threaten access to capital markets** – State and local governments (particularly larger areas) need to borrow money regularly. Paving roads, building schools, updating water systems – these projects can't be 100% funded with current revenue. Municipalities, even those facing financial difficulty, have enjoyed very low interest rates on newly issued debt based on the expectation that bondholders will get paid, particularly on General Obligation debt. If that expectation were ever challenged, borrowing costs would likely escalate significantly for the non-paying municipality, further exacerbating already strained finances. This is why even in some of the higher profile "defaults" in municipal history, namely New York in the 1970's and Orange County, CA in the 1990's, bondholders ultimately recovered their principal, albeit delayed. Any locality pondering bankruptcy through Chapter 9 filings would face a major economic disruption as well as a lengthy and extensive approval process that would carry significant penalties when attempting to re-enter the debt market in future years.

Caprin's disciplined investment strategy has been centered on a bias towards higher quality and liquidity, with a defensive posture against a potentially deteriorating credit environment. The problems facing state and local governments continue to warrant a diligent and proactive approach to security selection and portfolio construction. Negative headlines and publicity may pressure municipal bonds as an asset class and default concerns may pressure bonds issued by struggling governments. However, Caprin's conservative approach, process, and philosophy strive to provide clients with portfolios positioned to endure in this environment.

Excerpt from Caprin's 2009 review/2010 outlook newsletter, published January 2010:

Maintaining Higher Quality Bias

Anxiety over state and locality budget shortfalls was the topic of many discussions in 2009 and created a buzz in regard to some issuer's abilities to meet their debt obligations. Finances were stressed not only by constraints in traditional tax base and revenue sources but in some cases by the financial consequences of aggressive borrowing strategies. Some forecasters expect a rise in defaults of state and local general obligation municipalities due to the extended time required to realign revenues and expenditures. We believe many of these worries are overstated, especially in the states and localities in which we invest client portfolios. However, securities of issuers in areas of greater economic stress may witness price and liquidity challenges as the market digests how effectively budgets are managed in 2010.

Caprin's emphasis on high-quality, low-volatility investments remains consistent for our client portfolios. We continue our credit surveillance of portfolio holdings, seeking to minimize event risk and unwanted volatility. Our investment discipline seeks higher quality general obligation and revenue bonds issued by essential purpose ('public works') entities to achieve these goals. We will assess the recovery in 2010, evaluating state and local fiscal conditions, and realign portfolios as needed.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this piece, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion of information contained in this piece serves as the receipt of, or as a substitute for, personalized advice from Caprin Asset Management. To the extent that a reader has any questions regarding the applicability to their situation of any specific issue discussed above, they are encouraged to consult with the professional advisor of their choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.