

Monthly Investment Commentary



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After strong gains in July, stocks reversed sharply in August, continuing the tug-of-war pattern that has characterized equity returns through most of the year. The large-cap Vanguard 500 Index Fund fell 4.5% for the month, and the iShares Russell mid- and small-cap benchmarks dropped 4.4% and 7.4%, respectively. Foreign stocks were also down for the month, with the Vanguard Total International Stock Index Fund falling 3.2% and the Vanguard Emerging Market Stock Index Fund losing 2.2%.

Domestic fixed-income provided some positive news for investors in August as the Vanguard Total Bond Market Index Fund gained 1.5% for the month, and the Barclays 7 Yr Muni Bond Index rose 2.3%. The fixed-income returns abroad were also positive as the Citigroup World Government Bond Index returned 2% and the JPMorgan GBI-Emerging Market Global Diversified Index gained 0.7%.

This month we are sharing with you an in-depth commentary from one of our research providers, Litman/Gregory, on conditions in the municipal bond market. Litman/Gregory invests in municipals via outside bond managers; so much of their commentary is focused on the national municipal bond and is influenced from the perspective of those managers. We think their commentary is insightful and worth reading, at the end of their comments we have provided our own thoughts and conclusions on the Kentucky municipal market. Please let us know if you have questions or comments on the following:

Understanding and Evaluating Potential Risks in Municipal Bond Markets (by Litman/Gregory)

We have spent the last year and a half sharpening our focus on municipal bonds and the potential risks for that \$2.8 trillion market going forward. Diversified investment-grade muni funds play an important role in our taxable clients' fixed-income allocations. We always consider the tax implications of investment decisions made on our clients' behalf but tax-exempt income alone is not a reason to invest. Default rates for all municipal bonds have averaged 0.01% annually since 1970 (versus 1.57% for all corporate bonds), according to Moody's, and over the same time period, the depth and breadth of state and local debt has grown. That has given active managers a larger universe of investment-grade securities to choose from and (in our opinion) more opportunities to produce higher total returns.

That said, risks have clearly increased. The percentage of muni bonds currently backed by insurers has dropped from about 50% to 10%; some bond insurance companies like Ambac and MBIA forayed into businesses like mortgage-backed securities insurance and they have struggled to stay afloat following the housing meltdown. State and local municipalities face budget shortfalls brought about by the economic downturn and longer-term structural challenges due to unfunded pension and health care liabilities. A PIMCO study conducted in late 2008 reviewed U.S. municipal defaults as far back as the early nineteenth century and it found default rates ranging from 1.4% to 7.3% during

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economic depressions. While the contributors to the rising default rates varied across time periods, there were some familiar-sounding developments mentioned: large increases in debt, real estate booms, and the collapse of many banks.

All of that has led to our concern that defaults in the investment-grade muni bond market will increase above their historical average rate in the years ahead. On the one hand, we rely on all of our bond managers to avoid defaults so, in that sense, one could argue that as long as we have confidence in their credit teams, an increase in default rates might not be a concern. But even those muni managers who avoid defaults can watch portfolios lose value if investors' fears become contagious, leading them to demand higher yields (and depressing prices accordingly).

Headlines about state and local budget problems have not translated into a rash of large municipal bond defaults, but three events in the past three years have grabbed headlines. The northern California city of Vallejo declared Chapter 9 bankruptcy in May 2008, but it has continued to make all payments on approximately \$120 million in revenue bonds and reduced interest payments on about \$50 million in general fund debt. (We give more detail on types of muni bonds below.) On a much larger scale, in April 2009, the sewer enterprise in Jefferson County, Alabama, defaulted on \$3.1 billion in outstanding sewer revenue bonds. That default remains unresolved. More recently, the Pennsylvania capital city of Harrisburg announced its intention to default on \$3.3 million in bond payments due this month. Those payments are expected to be covered by the city's bond insurer.

While the muni funds we invest with have not been exposed to these defaults, one lesson we have learned is that understanding where future defaults might occur requires looking closely at the variety of municipal bonds held in our portfolios and the types of receipts that back them. It is important to note the differences between the muni market and the Treasury market. There is one issuer of U.S. Treasuries and those bonds are backed by the full faith and credit of the U.S. government. In contrast, there are approximately 50,000 municipal issuers and bonds can be backed by income taxes, sales taxes, property taxes, appropriations from the legislature, or a dedicated revenue stream from something like a toll road or a hospital.

Pre-refunded bonds have proceeds from a more recent bond sale held in escrow to pay interest and for that reason are considered among the safest muni bonds. But outside of pre-refunded bonds, investors need to be aware of three main categories of muni bonds and their characteristics when examining portfolio allocations. Here is a quick overview of each:

General Obligation Debt

General obligation (GO) debt is secured by the full faith, credit, and taxing power of the issuer. What that means in practice is that issuers use money collected for their general fund to pay interest, and bondholders have the right to force additional tax collection or legislative appropriation if the issuer

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defaults. Personal and corporate income taxes as well as sales taxes provide the revenues that go into a state's general fund. For smaller municipalities like cities, property taxes, and aid from the state can be used to pay GO debt service.

Lease-Obligation Bonds

Interest on lease-obligation bonds is also paid from a municipality's general fund, but there's a catch: the legislature has to formally approve the appropriation of interest payments. Because of that difference, lease-obligation bonds are generally rated one ratings notch below the GO debt rating of the municipality.

There are a number of well-regarded lease-obligation bond issuers. For instance, state university systems often use this type of debt to finance building construction, and investors then look to the state to make the appropriations to pay off the debt.

While a legislature could refuse to appropriate funds in the midst of a budget crisis, there have been very few cases where this has happened. The basic idea is that a legislature wouldn't dare forgo appropriation because that would harm their credibility in the marketplace and hike up their cost of borrowing. Still that doesn't mean these bonds are always a safe bet. Carol Flynn, director of municipal bond research at DWS, says her credit analysts avoid smaller municipalities that don't do much lease financing or have limited track records. They also closely examine how well the term of a bond matches the estimated life of the asset it finances. In addition, credit analysts often look for "cross-default" provisions in a security's documentation. Under this provision, a municipality automatically triggers a default on all of its lease-obligation debt if the legislature fails to appropriate funds for even one lease obligation.

Revenue Bonds

Revenue bonds are backed by a dedicated stream of revenues stemming from just about any municipal service one can think of. As a result, the credit quality of these types of bonds can vary widely. For instance, most portfolio managers have recently favored essential service revenue bonds (backed by power, water, and sewer enterprises) because they are considered less volatile and more secure than other revenue bonds. The issuers are generally large, with experienced management teams who provide detailed disclosure. In addition, because society can't easily function without these types of basic services, the issuers often have rate-setting autonomy, i.e., if they need more money to pay their debt, they can increase rates charged for their services.

Sales tax revenue bonds and higher education revenue bonds (backed by tuition and endowment monies) are also considered among the higher-quality revenue bonds. Some managers favor bonds backed by toll roads with established track records but they avoid financing start-up toll roads. For

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example, Flynn points to the Connector 2000 Association toll-road bonds issued in the mid-'90s. Flynn's credit team at DWS turned down that deal when it was offered. The issuer financing the 16-mile toll road in South Carolina expected to see 21,000 daily toll transactions and transactions have instead averaged 7,500 daily. With approximately \$200 million in debt, the issuer filed for Chapter 9 protection in late June. Other credit-intensive areas include hospital revenue bonds (which Flynn calls very "story specific") and housing revenue bonds, issued to finance multi-family housing or similar projects.

While some investors believe that any bonds with a pledged source of revenue are safer than GO debt, revenue bond holders do not have rights to other government assets or revenues in the event of a default—and there have been defaults. "There have definitely been hospitals that have gone bankrupt that were not bailed out," Flynn points out. Indeed, a recent Moody's study of municipal defaults showed that since 1970, the health care sector (along with housing project finance bonds) has had the highest number of defaults of any municipal sector.

To reduce the risk of excess borrowing, many states have also implemented limits on GO debt and that has had the impact of pushing more issues into revenue-backed structures not secured by a government's full faith and credit, according to PIMCO. Virtually non-existent at the time of the Great Depression, revenue bonds today account for almost half of the municipal bond market.

There are a whole host of other types of muni bonds that are outside the scope of this research update because they are generally not utilized in diversified investment-grade municipal bond funds. Taxable municipal bonds include pension obligation bonds and recent newcomer Build America Bonds. And then there is a merry band of acronyms including RAN (revenue anticipation note), TAN (tax anticipation note), and VRDN (variable rate demand note). These short-term notes are typically the province of tax-exempt money market funds.

Major Revenue Shortfalls and Political Gridlock Affect Debt Servicing

While there is still debate about whether the U.S. economic recovery will sustain itself or undergo a "double dip," there is little debate about the health of the states. In fiscal 2009, states saw a 16.9% drop in corporate income tax collections, an 11.2% decrease in personal income tax receipts, and a 6.2% decline in sales tax revenue, according to a report by the National Governors Association and the National Association of State Budget Officers. Despite enacting almost \$32 billion in tax, fee, and other revenue increases in 2010, additional declines of 5.8%, 2.8%, and 1% in corporate, personal, and sales tax receipts, respectively, are estimated for fiscal 2010. Overall, that amounts to an almost 12% decline in states' general fund revenue from 2008 to 2010.

Moreover, even if the U.S. economy avoids a double dip and sustains its recovery, an improvement in state and municipal budgets can lag overall economic improvement by years. State spending

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needed three years to recover following the nine-month downturn of 2001, according to the report cited above. And while sales and income taxes reflect economic volatility pretty quickly, property tax receipts generally exhibit a two-year lag versus changes in property values due to the time it takes for assessed valuations to change. That will have ongoing consequences for municipalities in states with large property-value declines like Florida, Arizona, Nevada, and California.

Does this make widespread defaults on GO debt likely? For a number of reasons outlined below, we think the answer is no. Still, there are two situations that can significantly raise the risk of a ratings downgrade or a delayed payment on a single issuer's debt service and the budget crises impacting the states currently makes those situations more likely to occur. The first event is a liquidity crisis stemming from a state's inability to balance its budget. California went through this crisis last year when it was forced to issue IOUs to contractors, local governments, and others due payment. Ironically, the IOUs protect the state's ability to keep enough cash in reserve for debt service, but the inability of lawmakers to successfully balance a budget can result in ratings downgrades. (Both Fitch and Moody's downgraded California's GO debt last summer.) Investors then demand a higher risk premium on the bonds so that yields rise and prices fall. In mid-August of this year, California's state controller said the state would again need to issue IOUs within a month if Governor Arnold Schwarzenegger and the state legislature cannot agree to a plan that closes a \$19 billion budget shortfall.

The second situation can arise from the first—that is, smaller local governments dependent on state aid can have trouble making payments on their GO debt if funds are withheld or delayed due to a state's liquidity crisis. New York school districts faced this type of hurdle in June when questions about the state's ability to transfer necessary funds in time to pay off short-term paper arose, according to Flynn. "We averted a crisis there but those are the types of things that come into play with the locals," she says.

While the risk of these events occurring has increased, there are a number of reasons why we believe they are unlikely to broadly occur across the diverse group of GO issuers held in our client portfolios. First, as we have mentioned before, most state constitutions protect GO debt holders above all other claims and states do not have the option of filing for Chapter 9 bankruptcy. Second, debt service on GO bonds as a percentage of revenues is generally in the single digits so defaulting on payments does not have the benefit of producing much savings relative to cuts in education, prisons, or health and human services programs. Third, it does not serve the issuers' interests. Defaulting or delaying payment on GO debt ultimately damages credibility and raises an issuer's cost of borrowing, the last thing an issuer needs when funds are tight.

Finally, large declines in property values by themselves do not necessarily make default on municipal debt backed by property tax more likely, according to managers we have spoken with. American Century Tax-Free Bond manager Alan Kruss points to the Detroit Public School district as one

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example. "Michigan has been in recession for 10 years and a receiver stepped in at Detroit Public Schools," he says. "Typically, the state will step in and use some of the state aid that would go to the school district to pay debt service on the bonds." (Note: Kruss does not own the bonds but points to them as one example of a school district under duress that continues to make payments on its bonds.) As an added indication of credit quality, managers we spoke with prefer voter-approved school district bonds with unlimited tax pledges from states like California and Arizona. Joseph Gotelli, portfolio manager of the American Century California Tax-Free Bond, notes that school district bonds may also offer relative value compared to city or county GO debt. "You're going to have much more support from the state level for school district bonds," he says. "So it's some more upside but much less downside." At the end of July, his fund had 20% allocated to GO debt with less than half of that allocation to state GO bonds. Of the remaining GO allocation, 6% was invested in bonds issued by school districts and community college districts.

We don't believe defaults will be widespread but price risk across the entire market remains. Any risk of a ratings downgrade to GO debt may cause investors to sell in favor of higher-quality bonds. This would also impact the ratings of lease-obligation bonds since they are automatically rated one notch below GO debt from the same municipality. Generally, however, a ratings downgrade is reflected in bonds' pricing well before the actual downgrade occurs and we have found the municipal-bond fund managers we invest with capable of navigating this type of risk.

In terms of revenue bonds, the risk of default is much more dependent on how the state of the economy directly impacts the individual issuer and the health of the revenue stream backing the bond. Unfortunately, because of the idiosyncratic nature of this market and the wide variety of issuers and backing, almost all of the bond managers we have spoken with—whether they are muni bond managers or not—agree that there is increased risk of default. But while revenue bonds will continue to present credit risk, we do not see as much potential here for contagion risk. It will be hard to make comparative assumptions across issuers given all the differences among them. That said, our conversations with muni bond managers have recently included more time spent looking "under the hood" at various revenue bond allocations and we anticipate that will continue to be the case going forward.

Unfunded Pension and Health Care Liabilities Are Structural Issues That Will Have a Longer-Term Impact on State Spending

The near-term budget woes cited above are cyclical problems brought about by economic weakness. But states and municipalities also face longer-term structural issues due to huge, looming unfunded pension and health care liabilities. A well-publicized report earlier this year from the Pew Center on the States estimated a \$1 trillion funding gap between the \$3.4 trillion pension and health care obligations of the states and the funds on hand to pay for them in mid-2008. Because the report did not include the severe investment declines experienced in late 2008, that calculation

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was likely optimistic. The University of Chicago's Robert Novy-Marx and Northwestern University's Joshua Rauh estimate a higher range of \$1.3 trillion to \$3.3 trillion in underfunding. They note that state funds use a long-term annual investment return of 8% to calculate the present value of future payments, a rate that may dramatically overestimate the funds' actual investment outcomes.

There's no question that unfunded pension and health care liabilities will impact state spending priorities going forward and there will be an increasing tug-of-war between civil servants wanting to protect their retirement benefits and the taxpayers called upon to finance those benefits. Solutions to deal with the problem include tax hikes, benefit cuts, a movement toward defined contribution rather than defined benefit plans, and the issuance of taxable pension obligation bonds. None of these solutions, however, should threaten debt service on GO bonds. In most states, these remain first claim on a state's general fund revenues (and relative to other state spending, a small claim in percentage terms). American Century's director of municipal research David Moore believes general obligation debt would even be honored above pension benefits in a situation where a pension fund ran out of money. "Pension benefits are a strong contractual obligation," he notes. "But a GO bond is a full faith and credit pledge in which the state irrevocably pledges its taxing power."

The poster children for this kind of test will most likely be Illinois and New Jersey, according to DWS's Flynn. But while the two states debate the appropriate level of current contributions to their pension funds, a number of years remain before their pension expenses reach a truly significant level. Flynn says the earliest estimates she has seen are for 2017 or 2018.

So the impact for muni bond investors in the near term will most likely be felt via ratings because states' actions to address underfunding in the coming years will determine how far state bond ratings can sink. Illinois' cumulative underfunding of pensions rose to \$19.2 billion at the end of fiscal 2008, up 59% from \$12 billion three years earlier. That was a significant factor in the state's April 2009 ratings downgrade. More recently, Moody's revised the outlook on New Jersey GO debt from stable to negative due to mounting pension obligation pressures. The state's funded ratio for pensions fell from 101% in 2002 to 70% in June 2008. (State pension systems have averaged funded ratios of about 85% in recent years.)

Yet positive outcomes are also possible: Moody's cites San Francisco's well-funded employee retirement system as one of the key strengths supporting its strong rating. And in August 2009, Moody's revised the outlook for West Virginia from stable to positive after the state increased its overall funding level on five retirement systems to 80%. The state had been one of the lowest funded states in the nation for years. [end of Litman/Gregory commentary]

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Kentucky's Fiscal Stress & Response

Like most states, Kentucky has been facing severe fiscal stress. Every even-numbered year, the Kentucky General Assembly is required by the State Constitution to pass a balanced budget. The governor's initial \$18 billion executive budget proposal for the fiscal 2011-2012 biennium addressed a \$1.5 billion projected shortfall and additional spending needs through a mix of one-time and recurring measures. The shortfall was addressed mostly by planned gaming expansion, expected to generate \$780 million of revenues. The legislature's alternative budget proposals did not include gaming expansion, relying instead on spending cuts, tax restructuring, and expected additional ARRA Medicaid stimulus funding. On April 15, the regular legislative session ended without a finalized budget plan.

In May, the governor called for a special legislative session to review a revised \$17 billion executive budget proposal did not include the gaming expansion, but did include state agency cuts of 3.5% and 4.5% for fiscal 2011 and fiscal 2012 relative to fiscal 2010 expenditures. Certain areas, including K-12 and higher education, saw lesser reductions. The new proposal also included federal stimulus (ARRA) funding, debt restructuring and other one-time resources. The legislature considered the governor's proposal and, after deliberation, approved a similar budget plan that the governor signed in June, with vetoes of certain items.

The enacted budget relies on \$811 million in ARRA funding (including medical assistance/FMAP and fiscal stabilization moneys), \$225 million in fund transfers, and \$461 million in cuts and efficiencies. The governor has been authorized to determine where these cuts and efficiencies will be applied. As of August, of the total \$192 million in cuts and efficiencies enacted for fiscal 2011, \$129 million have been implemented and another \$24 million in savings will result from the planned furloughs of state workers over the course of the year. Plans to cover the remainder (\$39 million) have not yet been released. The budget also relies on over \$200 million in debt restructuring (extending debt maturities for budget relief). The fiscal 2011 budget is structured to result in an ending balance of \$281 million (3% of revenues), to provide for adequate resources for the fiscal 2012 budget in the absence of ARRA funding. Budgeted ARRA moneys include \$238 million in revenue from an assumed FMAP extension. On August 10, Congress approved extension of the enhanced FMAP level, but Kentucky's additional revenue from this amount is not yet clear.

The prior ('09-'10) \$19 billion biennial budget also depended heavily on non-recurring resources, including beginning balances, fund transfers (\$433 million for the biennium), and reserve funds (\$191 million). It also included debt restructuring and borrowing from the Teachers' Retirement System in order to pay current costs for retiree healthcare.

Weaker-than-expected collections during 2009, mostly related to corporate income tax revenues but also sales and individual income taxes, led to a revised projection indicating a general fund

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revenue shortfall of \$456 million (about 5% of revenues). In response, the state enacted expenditure reductions of \$147 million and tax changes related to cigarette, tobacco, and liquor taxes projected to result in \$52 million in new revenues for fiscal 2009 and \$159 million in fiscal 2010. In addition, fund transfers of \$57 million from various available state funds and a transfer of \$216 million from the Budget Reserve Trust Fund (BRTF) were enacted. The remaining balance in the BRTF after the transfer was about \$7 million basically exhausting the "rainy day fund". The BRTF was taken to \$0 in fiscal 2002 following the 2001 recession.

Revenue Performance has shown some stabilization recently. General fund revenues were projected to decline by 2.7% in fiscal 2010. Actual performance, however, was better (-2.4%) resulting in a surplus of about \$27 million. Monthly revenue figures for May, June and July of 2010 have shown monthly year-over-year growth of 3.1% (May) and 4.6% (June and July).

Commonwealth Debt Burden and Pension Obligations

Kentucky relies on lease-supported debt for the majority of borrowing. As a policy, the commonwealth has limited debt service to 6% of total state revenues, a goal it has met consistently over the last 10 years. The 6% test generally applies to all debt service appropriated by the legislature -- including debt of the State Property and Buildings Commission, the Kentucky Asset/Liability Commission, state universities, the Kentucky Turnpike Authority, and certain debt of the Kentucky Infrastructure Authority, -- but it excludes Administrative Office of the Courts-related debt.

Commonwealth debt levels relative to 50-state medians are high. Kentucky's debt, as a percentage of personal income (5.4%), is more than double the 2010 state debt median of 2.5% for all states, ranking the commonwealth eighth highest. Commonwealth debt per capita was \$1,685 as compared to the 2010 state debt median of \$936, ranking the commonwealth 13th highest. Debt levels may increase, as the budget for the upcoming biennium includes authorization for additional debt.

Kentucky's retirement system funded levels are low, at 64% for the Kentucky Teachers' Retirement System and 48% for the Kentucky Employees Retirement System as of actuarial valuations on June 30, 2009. The commonwealth's liability for other post-employment benefits (OPEB, primarily healthcare) has been estimated at about \$11 billion. A special legislative session focused on retirement system reform was held in June 2008, resulting in cost savings measures including reductions in benefits for new hires, longer vesting periods for employees, limitations on cost of living increases, and a target date of 2025 for full annual required contribution (ARC) funding. The enacted budget complies with the schedule of payments associated with the ARC funding requirement.

SOURCE: MOODY'S

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Conclusion

Near-term, Kentucky has already and will continue to take steps to balance revenue and expenditures. It is important to note that all the focus is on the general fund's \$8.5 billion. Kentucky's total budget is \$28.9 billion: Federal (\$11.6b), Fees & Licenses (\$7.1b), Road (\$1.5b), Tobacco (\$154m). \$1-2 billion of adjustments do not seem as insurmountable. Undeniably challenges remain. Intermediate-term, we will be watching for revenue enhancements and the eventual rebuilding of the "rainy day fund". Longer-term, we think Kentucky must improve its unfunded pension, where it ranks poorly, and retiree healthcare obligations. We remain confident that it is highly unlikely of a default on our appropriation-based debt (Aa2/3, A+/AA-). Most importantly would be the ramification of future borrowing costs. We are especially comfortable with credits of our school district enhancement (KSDE) and public university intercept programs (Aa2). Education tends to be a priority politically. Portfolios can be anchored with these credits and then diversified with county & city general obligations (GO's), utility revenues such as water, sewer & electric, and a few positions within healthcare. We will continue to monitor conditions in Kentucky and the muni markets, please call us if you have any questions.

—CB&T Investment Team (9/10)

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