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MARKET Commentary

The Sorry State of the States

February 2011

The fiscal plight of the states and municipalities in the U.S. has dominated headlines in recent weeks. States face deep-rooted challenges—including reduced tax revenue, widening budget deficits, elevated unemployment, severe debt overhangs and crushing entitlement expenditures—that threaten to result in a nationwide fiscal crisis and losses to holders of municipal debt and other vested parties (most notably state pension beneficiaries). The much-publicized troubles of states' finances have resulted in increased volatility in the $3 trillion municipal bond market, where states and municipalities borrow money to fund operations and capital projects. While this news overshadows the market, the volatility presents attractive opportunities for short-duration investors who have the ability to perform the necessary due diligence that investing in the municipal market requires. We consider the risk-return tradeoff in select tax-exempt products—specifically pre-refunded municipal bonds—attractive and warrants consideration as a low-risk option to boost portfolio return in this historically low-rate environment.

The states' fiscal crisis is strikingly similar to the European debt crisis, which we have written about extensively in past months. Both crises resulted from the chronic mismanagement of fiscal policy and the accumulation of a suffocating debt load. The *Center on Budget and Policy Priorities* reports that states have been forced to close $430 billion in budget shortfalls in the combined fiscal years of 2009, 2010 and 2011. Fiscal 2012 is shaping up to be another challenging year, with 44 states projecting to record budget shortfalls totaling $125 billion. With taxpayers subjected to low income growth and elevated unemployment, state leaders have little option but to focus their deficit-reduction efforts on cutting spending. This is something that leaders have been reluctant, if not entirely unable, to execute in recent years.

Figure 1: Five Largest State Budget Shortfalls as a % of FY 2011 Budget

State	Projected 2012 Budget Shortfall	Shortfall as a % of FY 2011 budget	Ratings
Illinois	$15.0 billion	44.9%	A1/A+
Nevada	$1.5 billion	45.2%	Aa1/AA+
New Jersey	$10.5 billion	37.4%	Aa2/AA
Texas	$13.4 billion	31.5%	Aaa/AA+
California	$25.4 billion	29.3%	A1/A-

Source: Center on Budget and Policy Priorities

Pension Fund Problems

The fiscal strains on the states are magnified when one factors in the considerable funding shortfall of public pension funds. The funding shortfall of a pension fund is the amount that the present value of all future contracted pension liabilities exceeds the current value of plan assets. Estimating the true severity of states' funding shortfalls is by no means an easy task as the numbers are highly subjective and prone to gaming by officials. The degree of the funding shortfall hinges largely on the discount rate, or expected rate of return on plan assets. The relationship between the discount rate and funding status is inversely related; that is to say that increasing the discount rate lowers the funding shortfall and decreasing the discount rate has the opposite effect.

US Treasuries
As of 31-Jan

Benchmark	Yield
3 Month	0.15%
6 Month	0.17%
1 Year	0.24%
2 Year	0.57%
5 Year	1.94%
10 Year	3.37%
30 Year	4.57%

Bank of America/Merrill Lynch Indexes
31-Dec to 31-Jan

Index	Return
1-3 Yr Gov/Corp ≥ A	0.20%
1-3 Yr Municipals	0.19%
1-3 Yr Agencies	0.17%
0-3 Month UST	0.01%
S&P 500	2.37%

Contact Us

www.ClearwaterAdvisors.com
Trading@ClearwaterAdvisors.com

Source: British Bankers' Association, Federal Reserve, FDIC, US Treasury, Bloomberg, Barclays, Financial Times, JP Morgan, The Economist, S&P and Center on Budget and Policy Priorities

Analysts have called for pension fund officials to use increasingly conservative estimates of fund asset returns to reflect the ultra-low rate environment in which funds currently operate. A study released by five Stanford graduate students in April 2010 incited a heated debate on the severity of the funding shortfall of California's public retirement systems and centered on the use of inappropriate discount rates by fund officials. The study of California's public pension funds asserted that the three prominent public employee retirement systems, CalPERS, CalSTRS and UCRS, were understating their combined funding shortfall by $425 billion prior to the volatile events of 2008. This figure was unnerving when compared with the official projected combined funding shortfall of $55.4 billion by the retirement systems' boards and officials.

While these figures likely represent the extreme ends of the range for the true funding shortfall of the public pension funds, the charged nature of this issue—currently 2.6 million people rely or will rely on benefits from these three retirement systems—will demand that officials soon formulate a credible plan to address the problems facing public pension funds.

Figure 2: Risk-adjusted Pension Shortfall as of July 1, 2008 ($BN)

	Stated					Adjusted			
	Discount Rate	Assets	Liabilities	Unfunded Liabilities	Funding Ratio	Discount Rate	Liabilities	Unfunded Liabilities	Funding Ratio
CalPERS	7.75%	238.6	277.2	38.6	86.1%	4.41%	478.3	239.7	49.9%
CalSTRS	8.00%	161.5	177.7	16.2	90.9%	4.41%	318.2	156.7	50.8%
UCRS	7.50%	42.0	42.6	0.6	98.6%	4.41%	70.8	28.7	59.3%
TOTAL		**442.1**	**497.5**	**55.4**			**867.3**	**425.2**	

Source: SIEPR Policy Brief, April 2010

The situation is certainly grave, but not yet fatal. States can remedy the problem through mandating pensioners contribute a greater amount to their own retirement benefits, moving towards a defined-contribution framework, reworking crippling benefit contracts with current and future pensioners and contributing consistently to underfunded pension funds. Any resolution to this hot-button issue will take significant time and political will on the part of policymakers. One recent proposal that allows states to file for bankruptcy in federal courts, aimed to renegotiate pension contracts in an accelerated fashion, is premature in our opinion.

The Municipal Market

Many investors are discouraged from investing in municipal bonds because of their general unfamiliarity with the municipal bond market and its diversity of issuers and instruments. The municipal market consists of over 80,000 issuers compared with the corporate bond market's roughly 3,000 issuers. While revenue sources for corporate bonds are generally straight forward (cash from operations, current assets and ability to refund liabilities), revenue sources for municipal bonds are more diverse in nature. Revenue to repay municipal bonds is often determined by the use of the bond proceeds and can come from general or special taxes, revenue sharing agreements, monies from infrastructure projects (utilities, airports or hospitals) and refinancing. Understanding the health of municipal bond issuers and identifying their source of revenue to repay their bond issues is critical to pricing the risks associated with municipal bonds.

Figure 3: S&P Study of Municipal and Corporate Default and Recovery Rates

Security Type	AAA-AA	A	BBB	All Investment Grade	Recovery Rate on Defaults
Municipal	0.0%	0.1%	0.4%	0.2%	66%
Corporate	1.1%	3.0%	8.4%	4.0%	42%

Source: S&P U.S. Municipal Rating Transitions and Defaults, 1986-2009

Clearwater Advisors · 950 W. Bannock Street · Suite 1050 · Boise, ID 83702

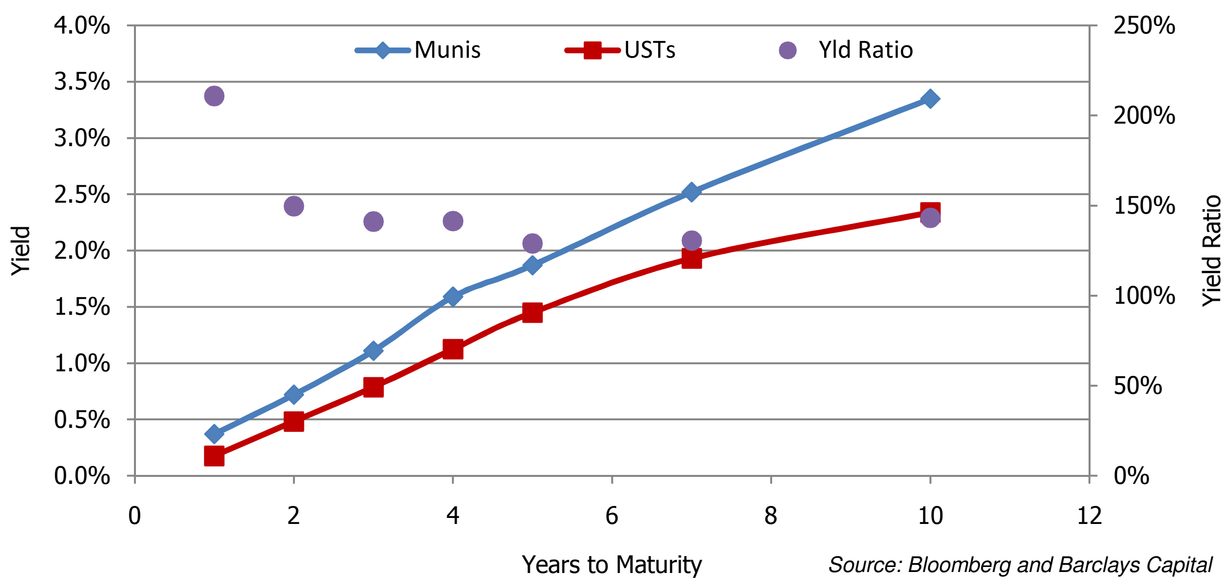
Municipal bonds are historically safer than corporate bonds. We do not expect this trend to reverse even with the recent market volatility. A 2009 study performed by S&P that analyzed the default rates of municipal and corporate bonds for the past 14 years highlighted that the default rate for all investment-grade municipal bonds was a mere 0.20%, or 2 defaults in every 1,000 issues. This compares to the default rate of 4% for all investment-grade corporate bonds. Not only are municipals less likely to default, but the recovery rate on municipal defaulted bonds is also significantly higher than that for defaulted corporate debt, at 66% to 42%, respectively. While the rate of default on municipal debt is certain to increase in the coming years, we deem the alarming estimates of defaults publicized by the media and certain analysts to be highly exaggerated.

For those currently active in the municipal bond market, we recommend staying with high-grade bonds of high-grade issuers like state general obligation bonds or essential revenue bonds (e.g., water and sewer bonds). In the hierarchy of priority of repayment and stability of revenue, these bonds enjoy the strong backing of general state taxing authority and steady revenue streams. Since the post-civil war period, no state has defaulted on its general obligation bonds. Essential revenue bonds, according to the same S&P report, enjoy a very low default rate of 0.03-0.04%, or 3-4 defaults in every 10,000 issues.

Pre-refunded Bonds

For investors looking to test the waters in the municipal market, we recommend starting in a safe segment which has become extremely attractive given the current volatility: pre-refunded bonds. These bonds are given the moniker "pre-refunded" due to a special provision which effectively allows a municipality to retire them by placing high-grade securities in an escrow account to cover all future coupon and maturity payments associated with the bond. Municipalities generally pursue a refunding strategy as a way to lower funding costs when market interest rates fall or to restructure their debt profile. The payment of coupons and principal becomes the responsibility of a Trust Agent who has been placed in control of assets in the escrow account as described by an escrow agreement. The municipal bonds being refunded are generally not re-rated and often carry their original ratings for the life of the bonds. When re-rated, these bonds typically receive AAA/Aaa ratings if the escrow account is filled with government securities. Not all escrow agreements are created equal, however, and investors must allocate the resources to understand such things as type of collateral allowed in the escrow account, substitutability of other collateral, irrevocability of agreement, status of call provision and lien holder for assets in the account.

Figure 4: US Treasury Yields after a 35% Tax Rate vs. Pre-refunded Municipal Yields (Left Axis); Yield Ratio of the Municipals vs. US Treasuries (Right Axis), as of 02.04.10



Source: Bloomberg and Barclays Capital

The relative value of short-term pre-refunded bonds, especially when the escrow account and instructions are irrevocably established and the escrow is comprised solely of government bonds (i.e., treasuries, debt guaranteed by the US Treasury and agency securities), warrants that short-duration investors consider the appropriateness of these securities for their investment portfolios. For example, current market rates indicated that a 2-year pre-refunded bond is yielding 72 basis points while a 2-year treasury bond is yielding only 48 basis points after netting the 35% federal tax rate (as most municipal bonds are exempt from federal taxes). This translates to a yield ratio of 150%; historically, this relationship has been in the 115-130% range.   In this low-rate environment, pre-refunded bonds may be a safe and attractive way to boost portfolio yield without taking on substantial credit risk.

Looking Forward

The states could certainly use some assistance to overcome the unprecedented challenges they currently face. A stronger-than-forecasted economic recovery or a meaningful rebound in the housing market would boost employment and revenue collected from taxpayers and businesses to assist in closing wide budget gaps. Continued gains in the equity and fixed income markets would also help to close the underfunded status of state public pension funds, putting less pressure on state officials to contribute to underfunded pension funds when discretionary cash is scarce.

While these outcomes are certainly favorable, policymakers must address the real sources of states' fiscal woes: rampant spending and debt accumulation. We are encouraged by leaders of select states who have worked to reduce spending in order to balance budget shortfalls and restructure crippling pension obligations. In the months and years ahead, we will continue to monitor policymakers' attempts to remedy the states' fiscal strains in an attempt to return to greater economic prosperity. In the meantime, we urge clients to consider investment opportunities in the less-utilized municipal market as attractive investment opportunities present themselves.

Please feel free to call the desk with any additional questions.

Form ADV Part II

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