Issued September 2010

Schroder US Tax-Exempt Fixed Income Team

How Safe are Municipal Bonds?

Recent media coverage of the ongoing negotiations to close budget gaps in some of the larger states, such as California, New York and Illinois, and the fiscal crisis in Greece and other European Union (EU) countries has stirred another round of questions regarding the safety of municipal bonds. Other stories have highlighted large unfunded state pension and postretirement liabilities, as well as several examples of municipalities that have either filed for bankruptcy or have discussed filing, including Vallejo, California, Harrisburg, Pennsylvania and Jefferson County, Alabama.

These recent media reports, in our view, misrepresent the long-term, strong credit fundamentals that municipals represent as an asset class. We would argue that municipals as an asset class rank high on the credit spectrum when evaluating the strength of fixed income credits. We acknowledge that state and local governments are facing extremely challenging times as they emerge from the worst recession in over 70 years. As in any recessionary environment, tax revenues decline while the demand for essential services increases the need for social service programs, unemployment benefits, schools, prisons, education and health care (Medicaid). To address this imbalance, we believe the vast majority of municipalities, well over 50,000 issuers across the country, are taking the painful, but necessary steps to balance their budgets. Additionally, although municipalities continue to face challenges, recent trends in revenue growth, based on US census data, have improved over the last two quarters.

Below are several reasons why we believe municipal credits will weather these difficult times and remain solid credits:

— The resources available to pay general obligation debt service to bondholders when compared to the United States and most developed countries in the world are high while overall debt burdens are low.

— Most state and local governments have balanced budget requirements and have been forced to raise revenues and cut expenditures over the last two years to balance their budgets.

— Long-term default ratios are extremely low for municipalities, less than 0.03% over the last 40 years for municipal bonds compared to 0.97% for corporates.[1]

— The average state general obligation bond is rated AA, the average county or city is A-rated, while the average US corporation is rated below investment grade. The rating agencies recently changed their methodology for evaluating municipals—using a global ratings scale which resulted in an overall increase in municipal ratings.

Diverse Revenue Base and Low Debt Burderns

When comparing the resources of larger municipalities to the world's largest countries, we find that resources available to pay municipal bondholders are high, and the size of existing debt burdens fairly low. Twenty-one municipalities, including states and large metropolitan districts, are in the top economies based on their GDP. In other words, states and large municipalities generally have a well-diversified economy and revenue base and have the ability to raise revenues and decrease expenditures as needed. While the following chart focuses on larger municipalities, we believe that since local governments and smaller municipalities are generally subdivisions of states, the fiscal health of municipalities is very closely tied to the health of states—especially

[1] Moody's Investors Service, US Municipal Bond Defaults and Recoveries, 1970-2009, February 2010

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given that states fund various programs and resources within municipal governments. We would note, however, that as smaller municipalities may have less diverse revenue bases than states, they may subsequently face their own unique challenges.

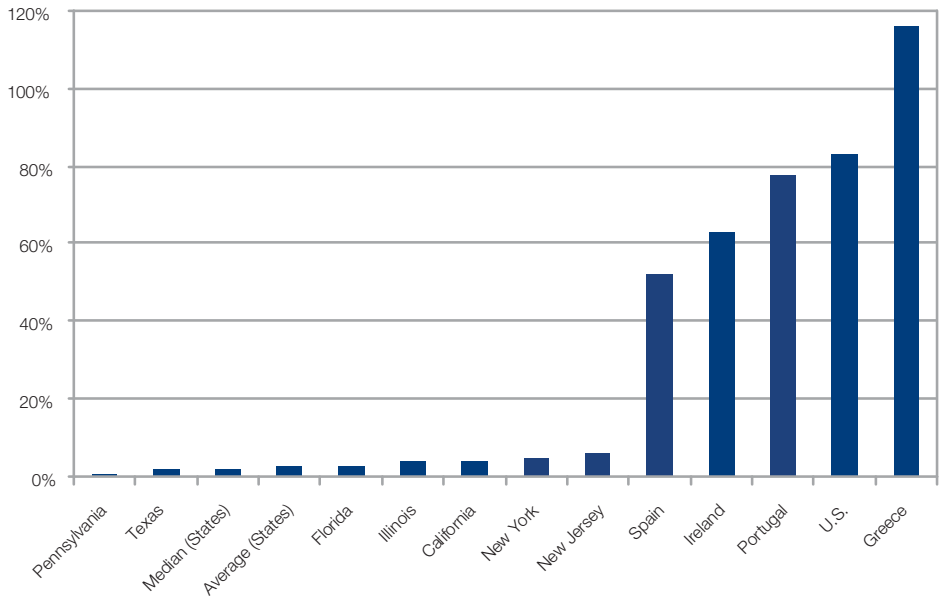
21 of the top Economies are U.S. States/Municipalities

Rank	Area	GDP
1	United States	14,441
2	Japan	4,911
3	China	4,327
4	Germany	3,673
5	France	2,867
6	United Kingdom	2,680
7	Italy	2,314
8	California	1,847
9	Russia	1,677
10	Spain	1,602
11	Brazil	1,573
12	Canada	1,500
13	New York-Northern New Jersey-Long Island, NY-NJ-PA	1,265
14	Texas	1,224
15	India	1,207
16	New York	1,144
17	Mexico	1,088
18	Australia	1,013
19	Korea	929
20	Netherlands	877
21	Florida	744
22	Turkey	730
23	Los Angeles-Long Beach-Santa Ana, CA	718
24	Illinois	634
25	Pennsylvania	553
26	Poland	528
27	Chicago-Naperville-Joliet, IL-IN-WI	521
28	Indonesia	512
29	Belgium	506
30	Switzerland	500
31	Sweden	479
32	New Jersey	475
33	Ohio	472
34	Saudi Arabia	469
35	Norway	452
36	Austria	415
37	Houston-Sugar Land-Baytown, TX	403
38	North Carolina	400
39	Georgia	398
40	Virginia	397
41	Washington-Arlington-Alexandria, DC-VA-MD-WV	396
42	Taiwan Province of China	391
43	Michigan	383
44	Dallas-Fort Worth-Arlington, TX	380
45	Massachusetts	365
46	Greece	358
47	Denmark	340
48	Iran, Islamic Republic of	335
49	Philadelphia-Camden-Wilmington, PA-NJ-DE-MD	332
50	Argentina	325
51	Washington	323

*Rank area GDP Current Price ($Billion) as of 2008
Source: IMF; Bureau of Labor Statistics; Merrill Lynch

When comparing the debt to GDP for some of the European Union (EU) nations to the US and the states, the overall debt burden for states is manageable. The average percentage of total debt to Gross State Product is 2.4%, while the median is 1.8% as the chart below illustrates. As further evidence of the manageable debt burdens for states, Standard & Poor's indicates the average annual debt service burden (annual principal and interest) to general expenditures is 3.7% for all states, while the median is 3.0%.[2]

Total Debt to GDP



*States are represented by Total Debt to Gross State Product (GSP)
Source: Standard and Poor's, Morgan Stanley as of December 2009

[2] Standard and Poor's, 2009 State Debt Report: Challenges Lie Ahead, December 2009

Municipalities face difficult challenges as they emerge from the recession. US unemployment is roughly 9.6% while some measures of underemployment are approaching 17%.[3] Municipal revenues are dependent on economically sensitive tax sources (property, sales and personal income taxes). Consequently, total state and local government tax revenues decreased by 6% from 2008 to 2009. Recently released figures indicate a reversal of the downward trend and slightly positive tax revenue growth. Figures for the first quarter 2010 indicate tax revenues were up by roughly 1% versus the first quarter of 2009—marking the second straight quarter of positive growth.[4] Preliminary second quarter data indicates that the upward trend continues with overall state tax revenues growing by 2.2% compared to the same quarter a year earlier.

State and local governments have a long history of managing through difficult periods and making the tough decisions to balance their budgets. In the last two fiscal years, states cut $75 billion in expenditures (base reduction of 10%) and raised $27 billion in new revenues. Expense cuts were broad based with 26 states employing layoffs and 19 states using furloughs to reduce personnel costs.[5] The National League of Cities recently reported that 70% of their members surveyed were implementing a combination of personnel and benefit reductions and cuts in service to balance their budgets.

Historically, state and local governments generally lag economic recoveries by at least a year to a year and a half due to their annual or bi-annual budget and revenue collection. Conversely, corporations are typically able to respond more quickly with job cuts, expense reductions and productivity increases. We would expect municipalities to continue to reduce expenditures and raise revenues to balance their budgets over the next several years.

Recent discussions on municipal credit quality have focused on unfunded pension and post-retirement obligations (OPEB) liabilities. The Pew Center for the Study of the States released a report earlier this year which highlighted a $1 trillion gap for states and participating localities. The report is an important addition to the debate on the subject of funding public plans but, in our opinion, misrepresents the immediate significance of an unfunded pension liability which in of itself does not cause a fiscal crisis. Pension costs are amortized over long periods of time and account for only 3% of total state and local government annual expenditures.

The actual funded ratio for state plans in particular is 80% according to Standard and Poor's which is higher than the levels in the 1970s, similar to the levels in the 1980s but less than the 100% ratio at the end of 2000. The major difference between today's funding levels and those almost a decade ago is a function of the decline in the equity markets. Investment earnings contribute roughly 60% of the total funding for public pension funds.[6]

Over the last two years, states in particular have made a broad range of changes to reduce long-term liabilities by increasing annual contribution rates, reducing benefit levels and extending vesting, age and service requirements. However, there are several states and participating localities (Illinois and many of northeastern states) that have funding ratios well below the national average and generous benefit packages due to the penetration of union influences. Additionally, states and local governments will need to address their long term OPEB liabilities over the next several years.

[3] US Department of Labor, September 2010
[4] US Census Bureau
[5] National Governor's Association and National Association of Budget Officers, Fiscal Survey of the States: June 2010
[6] National Association of Retirement Administrators, Issue Brief, March 2010

Default Rates: Muncipals vs. Corporates (1970-2009)

Rating Category	Muncipal	Corporates
AAA	0.00%	0.56%
AA	0.06%	0.58%
A	0.03%	1.42%
BBB	0.13%	4.89%
Investment Grade	0.07%	2.23%
High Yield	4.29%	32.71%
All Grades	0.10%	10.14%

*Average cumulative rolling 10-years default rates. 1970-2009: Moody's refers to high yield as "speculative grade" in its study, past performance is no guarantee of future results.

Source: Moody's Investor Services

Low Historical Default Rates

Default rates on municipals are historically low when compared to corporate credits[7]. According to Moody's, the 10 year average cumulative default rates for municipals are less than .10% (1/10th of 1 percent) over the last 40 years! (See chart above). Defaults are generally centered in industrial development projects, unsecured health care facilities and more recently in real estate development projects in the areas hardest hit by the decline in real estate (Florida, Arizona, Nevada and California). Corporations are 98 times more likely to default than municipalities generally because municipalities have the ultimate pricing power—the ability to raise taxes.

Even when looking back to the Depression era, municipal defaults were manageable. A study published by the National Bureau of Economic Research (NBER) in 1971 reports that roughly 7% of total municipal debt missed an interest or principal payment at some point during the period but only $100 million (or 0.5%) of the total dollar amount of municipal bonds outstanding was never repaid to bondholders. Similarly, the default rate on municipal debt during the post war period (1949 – 1965) was equally low—just 0.3%.[8]

Looking at more recent statistics, the largest amount of municipal debt that defaulted since the 1930's occurred in 2008 when $8.2 billion defaulted by a total of 162 issuers—only 0.29% of the $2.8 trillion in municipal debt outstanding. Since 2008, the trend has improved with $6 billion defaulting in 2009—half of which were from real estate development projects, called community development districts, that went bust in Florida. Through the first six months of 2010, $1.5 billion is under default from 30 issuers.[9]

Bankruptcies are rare in the municipal market. For 2009, only 12 issuers (out of 50,000), filed for Chapter 9 bankruptcy protection. States are prohibited under the US code from filing bankruptcy and the laws pertaining to whether a municipality can ultimately file for bankruptcy vary from state to state. Twenty-six states outright prohibit bankruptcy filings and many states have specific procedures in place in the event that a municipality exhibits extreme fiscal stress—including a form of state receivership and/or the appointment of a special authority with specific powers.

One of the most publicized bankruptcy filings was Vallejo, California, a town of 19,000, which filed in 2008 to force the police and fire unions to renegotiate excessive contract arrangements. Jefferson County, Alabama and Harrisburg, Pennsylvania are two other large municipalities that are currently under duress and are exploring different avenues to resolve their issues to prevent a bankruptcy filing. Jefferson County entered into interest rate swap agreements pertaining to their water sewer debt that are now valued at $3 billion versus $300 million in annual revenues.

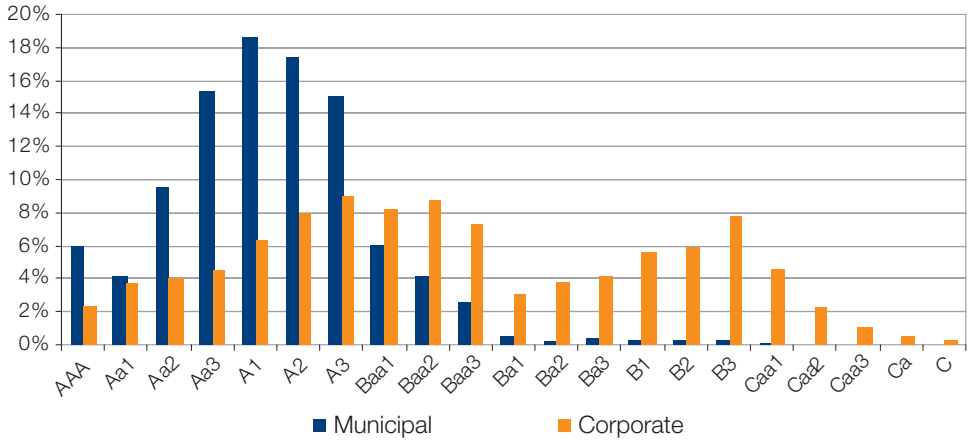
[7] One cannot necessarily infer from overall default rates any one particular municipal issue is necessarily more creditworthy, but the historical default rates do indicate that the safety of municipal issues should not necessarily be judged in the same manner as other asset classes—such as corporate bonds

[8] National Bureau of Economic Research, authored by George Hempel, The Postwar Quality of State and Local Debt, 1971

[9] Bloomberg News

Harrisburg, Pennsylvania is experiencing fiscal stress due the City's guarantee to cover debt service costs on a trash to steam incinerator plant that is not generating enough revenues to cover $20 million in annual debt service and swap payments. Assured Guaranty Municipal Corp which insures most of the incinerator debt has made the payments to bondholders while the City continues to debate several alternative plans.

Municipal vs. Corporate Ratings, January 2010



Source: Moody's US Municipal Bond Defaults and Recoveries, 1970-2009, February 2010

High Levels of Credit Quality

Municipalities, when compared to corporate bonds and other fixed income sectors are a highly rated asset class by the credit rating agencies. As noted previously, the average state general obligation bond is rated AA, the average county or city is A-rated, while the average US corporation is rated below investment grade. While we believe additional due diligence is required on individual municipal bond issues beyond the rating agencies, the high overall level of credit quality when compared to corporates, as well as other fixed income sectors, reinforces our opinion that as an asset class they offer high levels of credit quality.

Additionally, Moody's and Fitch rating services both recently implemented a major change in their approach to rating municipals. Traditionally, these two rating agencies used a separate rating scale that emphasized the ordinal ranking of credit risk within the municipal sector. In the spring, both agencies, somewhat prodded by investor and Congressional pressure, implemented a global ratings scale approach whereby municipals are now compared to all global fixed income credits including, but not limited to, sovereign governments, corporate obligations and structured finance (mortgage and asset-backed securities). As a result, Moody's recalibrated nearly 18,000 issuers and security combinations with 34 states and numerous local governments receiving a lift in their ratings. Standard and Poor's indicated that they had already been evaluating municipal credits on a global ratings scale and reported that in 2009 they upgraded over 2,300 issues versus roughly 350 downgrades.

Municipalities in general are facing difficult conditions as they emerge from the recession that officially ended in mid-2009. Due to the continuing demands on municipal services in the face of flat to moderately improving revenue conditions, we would expect some municipalities to struggle, but generally history has shown that they can weather these fiscal storms due to their diverse revenue bases and moderately low debt burdens. With a market as deep and diverse as the municipal market (encompassing over 50,000 issuers and $2.8 trillion in value), there will be a handful of municipal issuers that generate headlines in the media. Overall, we are confident that municipals as an asset class will continue to offer value in high levels of credit quality.

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September 2010

Important Information

Source: Schroders, unless otherwise noted.

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