

State of the States: December 2010 Update

Executive Summary

- Over the past year, there has been an unprecedented divergence in the range of credit quality available within the municipal market.
- While many states have implemented stop-gap measures to alleviate the hemorrhaging, investors should be on the look-out for resolution that effectively eliminates the structural imbalances inherent in most state budgets.
- Public pension reform will be a slow process requiring ongoing and consistent monitoring. While a conservative approach should continue to be employed, this period provides opportunity for educated and discerning purchasers.

As 2010 draws to a close, municipal investors will need to delineate between disparate state and local government credit qualities.

Beginning in the second half of 2008, as the impacts of the economic downturn took effect, municipal revenues (taxes on personal income, sales, and corporate income) contracted as operational costs continued to increase — leading to severe budget shortfalls. The American Recovery and Reinvestment Act (ARRA), passed by congress in February 2009, created a partial relief by diverting aid directly to states' fiscal 2009-2011 budgets. Analogous to a state selling assets or issuing short-term debt, this cash influx served as a one-time relief effort.

These efforts did not, however, address the expenses that have caused the structural imbalances within state finances and budgets. These outlays include, but are not limited to, ever-growing debt-service expenses, increasing compensation, and underfunded pension and other post-retirement employee benefits. At present, the economies of Illinois, California, New York and Arizona are the most burdened. Unsurprisingly, these are the states upon which the market has assigned the greatest risk premium.

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An Issue of Expenses, Not Revenues

In spite of recent reports reflecting state revenue gains (three straight quarters of increased revenue, year over year) and projections of a return to peak revenue levels, overall government credit quality will remain compromised until the structural issues are addressed. At the root of the problem lies an expense issue that will require a stronger antidote than the one delivered by reductions in operational and payroll expenses. (Since January 2009, 360,000 / 1.8% of total public sector jobs have been cut.)

Rather, governments will need to reduce costs across all major expense categories:

K-12 Education 26% of state spending	Medicaid 13%	Higher Education 12%	Transportation 7%	Corrections 5%	Other* 36%
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* Note: "Other" includes a wide range of categories such as aid to municipalities, pension and OPEB benefits, economic development, environmental projects, state police, parks and recreation. Due to reporting differences, it is impossible to aggregate these expenses across states.

Those states that effectively enact changes across the expense spectrum will succeed in maintaining a strong credit quality. Those efforts enacted during 2009 and 2010 to address underfunded pensions and post-retirement employee benefits are as follows:

- 13 states cut current employees benefits;
- 12 states raised the required contribution rate to the state retirement system, with Utah closing its defined-benefits plan to new workers;
- 6 states raised the minimum retirement age for public employees; and
- Missouri overhauled its employee pension system, thereby saving \$662 million over the next ten years.

At present, New Hampshire is considering a pension reform that would allow municipal employees to make tax-free contributions to pooled-investment accounts managed by the employee union. The accounts would cover retiree health care costs, estimated to save \$60 million per year.

The Pension Situation

The Government Accounting Standards Board (GASB) recently released several recommendations regarding the accounting and disclosure of state and local government public pension financial statements. The recommendations include quantifying an acceptable rate-of-return for calculating pension liabilities. Further, states will need to disclose pension liabilities every year, will have a full actuarial valuation performed every two years, and will be required to immediately expense any loss of 15% or more in the value of a plan's assets in any given year. These recommendations are currently in a "public review and comment" period.

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No state, either the reddest or bluest, can quickly enact legislation that will effectively eliminate the existing structural imbalances. Rather, this will be an incremental, legislative process that investors will need to monitor to better understand the intermediate- to long-term outlook of each state.

Local municipalities are, to a significant extent, beholden to the financial circumstances of their state. The funding mechanism for local governments within a state (e.g., state "aid" or "support" as a percent of local government budget and state property tax relief programs) is as significant a factor on a local government as falling property values and their effect on property tax revenues. This structural funding methodology can, depending on the state, increase or decrease the stress on local government.

Current Strategy

We continue to structure portfolios with the following characteristics and methodology:

- High credit quality when investing for client portfolios
- Essential service revenue-backed bonds
- General obligation debt of strong and fiscally sound states and municipalities
- College and university revenue-backed bonds of well-endowed institutions
- Escrowed and pre-refunded bonds in portfolios when appropriate
- Market dislocation utilized to exploit swap opportunities
- Incremental addition of longer dated maturities at historically attractive ratios to U.S. Treasuries

In Summary

Vigilance is needed at a heightened level, such as has not been required since the Great Depression. State and local municipalities suffer from weakened credit profiles, and yet the extent to which an issuer is under stress is less systemic than portrayed by the media. For example, there is limited risk of sector-wide defaults resulting from a single state or larger municipality defaulting on general obligation debt. Glenmede's fixed-income department believes the occurrence of such a default would likely cause a dislocation of market prices, perhaps presenting an opportunity to buy bonds of high-quality issuers where there is existing exposure. Traditionally, times of fear and uncertainty have proven to be excellent buying opportunities.

To assign the same risk profile to all general obligation municipal debt is just as wrong now as it was (with a positive spotlight) in more robust economic times.

For further reading, please find an enclosed link to a recent New York Times' article:

<http://www.nytimes.com/2010/12/05/us/politics/05states.html?pagewanted=1&r=1>

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