

'The State of the States' – Glenmede's Update on the Municipal Bond Market

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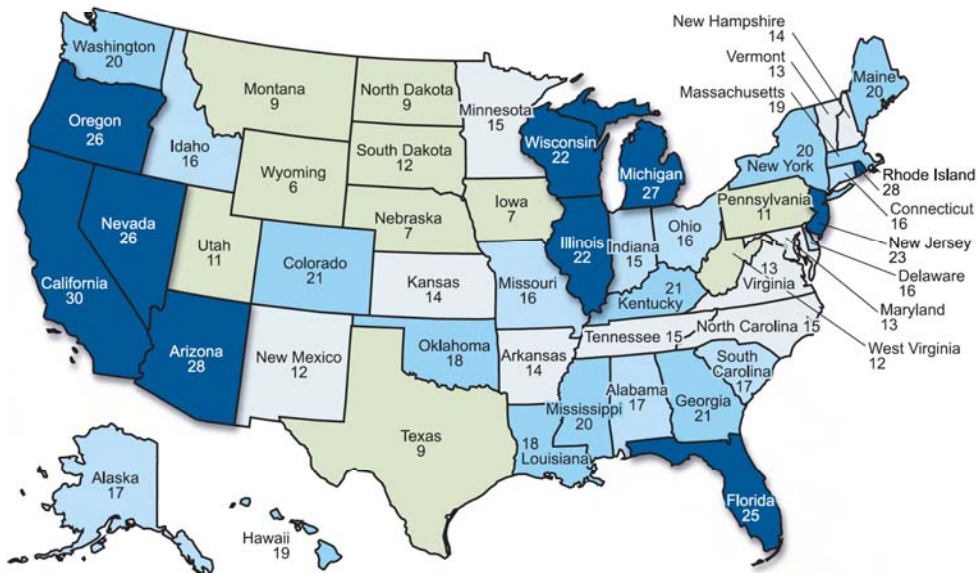
Earlier this decade, many states increased the level of services provided to residents with funding from a variety of revenue sources, including: income taxes, sales taxes, and real estate taxes. For many states, the increased funds were the result of higher overall economic activity, and not the result of higher tax rates. This changed in 2008 as revenue sources declined significantly and states were unwilling or unable to cut their expenses to offset the reduced income. The problems which have since resulted have been widely discussed and researched. A new research piece prepared by the Pew Center on the States, 'Beyond California: States in Fiscal Peril,' examines the considerable financial stress facing municipalities due to the slow economy, high unemployment rates, lower property tax payments and even poor investment decisions on existing debt. This, coupled with the fact the states have higher administrative and pension costs, will prove to be a challenging environment over the near term.

According to the Pew Center on the States study, the states experiencing the most financial difficulty are: California, Arizona, Rhode Island, Michigan, Oregon, Nevada, Florida, New Jersey, Illinois, and Wisconsin. Interestingly enough – Florida, which has been in the headlines for some time, received the designation of being the "best of the worst". Slightly better performers than the bottom ten are: Colorado, Georgia, Kentucky, New York and Hawaii.

Exhibit A-1. How does your state compare with California?

Using indicators chosen to gauge California's fiscal conditions, Pew Center on the States collected data for all 50 states. Pew's researchers then "scored" the states based on the results, with California ranking highest at 30.

Most similar to California       Least similar to California



NOTE: For components of individual state scores, see Exhibit A-2, p. 65.
SOURCE: Pew Center on the States, based on analysis of data from the Nelson A. Rockefeller Institute of Government, the Center on Budget and Policy Priorities, the U.S. Department of Labor's Bureau of Labor Statistics, the Mortgage Bankers Association, the Public Policy Institute of California and the Pew Center on the States' Government Performance Project; best available data as of July 31, 2009.

If economic growth continues to be slow and revenue sources do not improve, states will likely experience more severe budgetary problems. While the current economy has put many states' finances under a microscope, it is clear these states poorly managed their budgets even before the economy faltered. Thus, the economic downturn exacerbates an already fragile situation. We have further concerns that states and municipalities are not adequately funding their pension plans; an issue that will have to be addressed.

So what is an investor to do?

Many of the states on the top 10 list are high tax states. For an investor subject to a high state-income tax rate, owning out of state bonds is rather punitive. We realize it can be painful to pay up to 11% in state income tax on municipal yields already at historic lows, but we highly recommend diversification across the country without regard to residence. After all, the goal of a municipal bond portfolio is to provide safe, federally tax-exempt income so you can sleep at night.

One of the ways we provide peace of mind is by recommending a larger allocation to municipal bonds that are pre-refunded or escrowed to maturity in US Treasuries. This provides an investor with tax-exempt bonds that have US Treasuries set aside to pay principal and interest when due. For fully discretionary clients with no restrictions, we recommend moving a portion of the bond portfolio in to this strategy. However, pre-refunded bonds tend to trade at a high premium and may not be suitable for all accounts.

While we remain concerned about the financial deterioration of many states, especially those listed in the top 10, we note that municipalities generally have higher credit characteristics and more remedies for default than corporations. Municipalities can raise real estate and school taxes, cut services (close libraries, shut down rec centers) raise trash fees and work on other solutions for cutting the budget. The key question is whether lawmakers have the political will to make the difficult decisions.

As a rule, Glenmede has always focused on the underlying credits of issuers. In addition, over the years ratings agencies have done a fairly good job of analyzing municipal risk. The downfall of most credit rating companies and bond insurers came when they attempted to expand their business lines into more esoteric mortgage related debt structures while not fully understanding the associated risks. Our goal in managing fixed income is to create portfolios which acknowledge the above stated risks and withstand the stress of a continued economic downturn.

A greater challenge exists for issuers highly dependent upon state governments for a majority of their funding. For example, a small state university that relies on government appropriation to cover a significant portion of its operating expenses could experience more problems than a large state university with a diversified revenue stream. The same concern exists for small townships that have become overly reliant upon state funding which may not exist in difficult economic environments. Therefore, regardless of the state, our focus remains on general obligation and essential service issuers (ie water and sewer) whose surrounding areas are economically strong and diverse while not being heavily dependent on outside funding.

We anticipate there will be much in the press about the economic troubles of municipalities as municipal debt has traditionally been considered a safe investment. We will, as always, keep our clients informed and we expect to maintain an ongoing dialogue as news develops and questions arise.

Average Cumulative 10-Year Default Rates 1970-2006

Rating Category	Municipals	Corporate
Aaa	0.00%	0.52%
Aa	0.06%	0.52%
A	0.03%	1.29%
Baa	0.13%	4.64%
Investment Grade	0.07%	2.09%
Speculative	4.29%	31.37%
All Grades	0.10%	9.70%

Source: Moody's Investors, The U.S. Municipal Bond Reporting Scale, March 2007

To view the entire Pew Center on the States report, please visit: <http://www.pewcenteronthestates.org>

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If you have questions regarding your municipal bond portfolio,
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