

## Municipal Bond Market in Transition

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This year saw more upheavals in the municipal bond market since the Tax Reform Act of 1986. At this point, halfway through 2008, it is instructive to reflect on what has changed and to consider the implications for investors. This commentary will expand upon some points that we made in the 2<sup>nd</sup> quarter commentary dated 7/11/2008. We will focus on 5 key factors, put them in perspective and show how they will affect the market going forward. These factors are:

- Downgrades of Bond Insurers
- New Issue Volume and Credit Structure
- Global Ratings
- State and Local Revenues
- Kentucky V. Davis

### Downgrades of Bond Insurers

The downgrade of formerly triple A bond insurers changed the dynamics of the municipal bond market and removed one of the fundamental assumptions that guided some market participants. As Table 1 below shows, at the beginning of 2008 seven bond insurers were rated triple A. By the beginning of the second quarter of 2008, four insurers were rated triple A, the others having been downgraded to the A category due to subprime exposure. By the end of the second quarter only two of the original seven retained the triple A rating, and Berkshire Hathaway was a new entrant into the field. Three of the insurers (CIFG, FGIC and XLCA) were further downgraded to non-investment grade. The downgrades of the two insurers with the largest market share as of year-end 2007, MBIA, now rated A2/AA and Ambac, now rated Aa3/AA, raise questions about their ability to insure new issues in their current configuration. Most recently, on July 21 Moody's placed the Aaa ratings of FSA and Assured on review for downgrade. To date FSA and Assured retain a stable outlook from S&P and Fitch.

**Table 1: Triple A Bond Insurers**

January 1, 2008	March 31, 2008	June 30, 2008
Ambac	Ambac	Assured Guaranty
Assured Guaranty	Assured Guaranty	FSA
CIFG	FSA	Berkshire Hathaway
FGIC	MBIA	
FSA		
MBIA		
XLCA		

Source: Rating Agency Websites

Today, bond issues generally trade according to the financial health of the underlying credit, which is the perspective that Samson has always relied upon when purchasing bonds for our clients' portfolios. The present environment has created a wide range of interesting opportunities for municipal bond investors and the rest of the market is following suit conceptually, if not in practice. We recognize that the market does place some value on insurance enhancements (the impact of Moody's actions on FSA and Assured has yet to be determined) and we incorporate that into our purchasing decisions, but our fundamental credit analysis is the same regardless of the presence of insurance. However, dislocations in the market have arisen which, in some cases, indicate that insurance has punitive implications. A credit with non-Triple A insurance can trade at a higher yield than that same credit without insurance. The field of monoline bond insurance continues to be in flux, as there is a possibility of other new providers as well as the emergence of some of the older entities under new names.

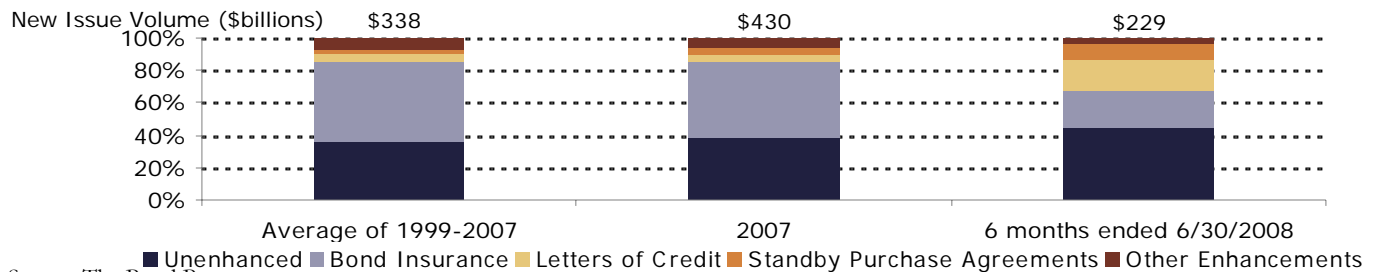
## New Issuance Volume and Credit Structure

While 2008 new issuance is on pace to modestly exceed the \$430 billion issued in 2007, the character of the market has changed. Structure and credit enhancement features are significantly different from 2007, and indeed very different from characteristics in the nine year average from 1999-2007.

Chart 1 below shows the major differences which reflect the problems of the bond insurers:

- Bond insurance declined to 23% of the new issue market, less than half the average for the past 9 years.
- Letters of credit increased to 18% of the new issue market, more than 3 times the average for the past 9 years.
- Standby bond purchase agreements, used in variable rate demand bonds, increased to 10% from the 2% average.
- Unenhanced bonds increased to 45% of the new issue volume.

**Chart 1: Credit Enhancement Profile of New Issues**



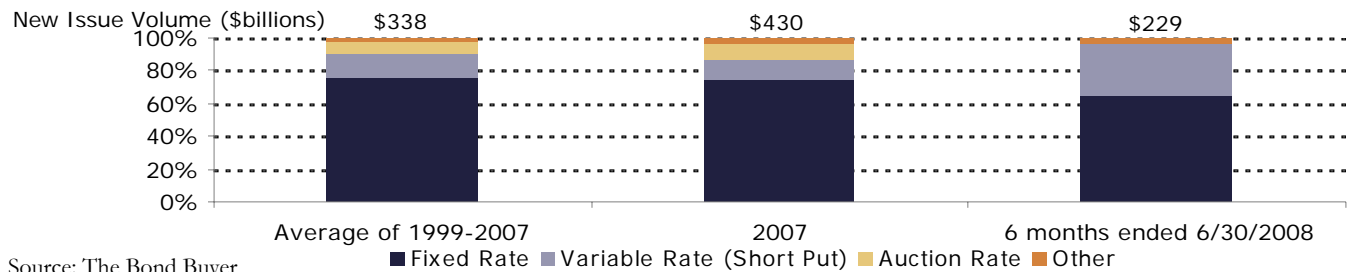
There are many implications for investors in this new municipal credit enhancement environment, which change the character of what we consider when we diversify portfolios. Historically, municipal portfolio diversification revolved primarily around issuers, geographic location and security (e.g., revenue, general obligation). Over time, the importance of a diversified municipal portfolio declined in many investors' eyes due to the "homogenization" of issues enhanced with financial guarantor triple As. That era has ended and today's municipal investors must readdress portfolio diversification along the traditional lines, but also in the context of financial guarantor risk. In addition to relying primarily on underlying issuer strength, Samson has always diversified client portfolio exposure to financial guarantors as a matter of course. This is particularly relevant in the short term market, where variable rate demand note issues may be backed by a letter or line of credit of a financial institution.

A positive for investors in the present environment is the large percentage of unenhanced bonds presently being issued. Over the past two decades, as investors and issuers became used to insurance, many large A and double A bond issuers would purchase insurance at very low costs in order to lower their borrowing costs - from already low levels, since the bond insurers typically provided credit enhancement only to strong issuers. In the present environment, the stable A and double A issuers are not as economically motivated to use insurance since bona-fide triple A insurance is more expensive today (premiums are higher) and the A and double A insurers do not provide the issuer with lower cost financing. Today's investor benefits from the higher yields available on the un-insured debt. Bond insurance had taken the security selection process out of investing by homogenizing credits and squeezing spreads. Now, with insurance itself impaired, investors with credit expertise can pick among the issuers for those with the best total return prospects. For the last two decades, the bond insurance industry earned the yield differential between a triple A rating and an issuer's actual rating in the form of insurance premium. Today that yield differential is available to the informed investor, which can be a very attractive opportunity given the naturally high credit quality of municipal bonds.

The mix of fixed rate bonds, variable rate bonds, put bonds and auction rate securities was markedly different in 2008 than in prior years. Chart 2 below shows changes to the structure profile of new issue debt, which include:

- A significant increase in variable rate and short put bonds. This reflects issuers converting from auction rate securities into structures with annual or multi-year put features.
- New issuance of auction rate securities was essentially non-existent in 2008, a function of the widespread problems in the overall auction market.

**Chart 2: Structure Profile of New Issues**



Source: The Bond Buyer

Changes in security structure have implications for the mix of investments selected for our clients’ portfolios. Puttable bonds are somewhat less liquid in today’s environment than serial or bullet maturity bonds, since the repayment of the bond on the put date is based on the issuer’s market access to sell new bonds. Puttable bonds are usually cheaper than non-callable bonds and we typically target small allocations to a portfolio to modestly increase the yield while still owning strong credits.

**Global Ratings**

The discussion of global ratings – a rating system where all sectors, including municipal and corporate bonds, are rated on the same scale – began in earnest in 2003. This discussion followed the release of a Moody’s default study on rated municipal bonds from 1970-2000. The study showed that Moody’s-rated municipal bonds defaulted at a much lower rate than similarly rated corporate bonds. Out of 28,000 unique issuers there were just 19 defaults for a cumulative default rate of .03%, compared with 2.32% for all corporate issuers. At the request of a few issuers in 2003, Moody’s began to use global scale ratings for taxable municipal issues, but ultimately only seven global scale-rated issues were completed.

The tumultuous markets of 2008 focused more attention on the ratings in general, and there has been a movement among some state officials to show ratings on the global scale, where many of them would be re-rated into the top ratings categories. Comments from the market led Moody’s to propose a move to a single rating scale for all municipal issuers. Moody’s has indicated that they will include qualitative factors in addition to probability of default in their analysis. They have also indicated that they will update the market with a timeline of any ratings transitions by the end of July.

In addition to the actions taken by the rating agencies themselves, Congress has also taken an active approach to the ratings dilemma. In late June, Rep. Barney Frank (D. MA) brought two bills to the House of Representatives that focus on universal ratings and expanding the ownership of municipal bonds. While the Washington action is in an early stage and may not fully develop until next year, it represents a concerted effort by lawmakers to address the complexities and inconsistencies of rating methodologies.

S&P has stated they already have been using a global rating for several years. Moody’s recalibration of the ratings may make some investors and issuers happier; however, we live in an age where credit ratings are in flux. Having a higher rating will not stop us from doing our due diligence on the credit.

**State and Local Revenues**

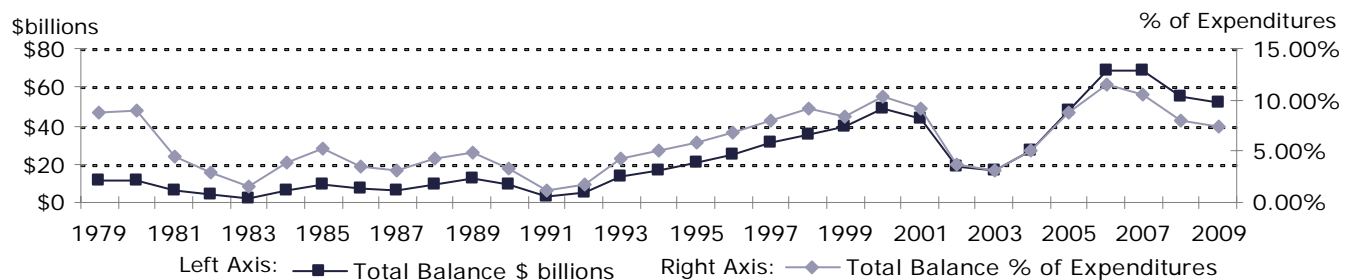
The subprime problem and downturn in housing values are the next pieces in the municipal market’s second quarter saga. The major source of revenues to local government is property taxes, while the major sources of revenues to state governments are sales, income and corporate taxes. In those areas where property values have declined, it generally takes several years to see a major reduction in taxes because of the length of time it takes to reassess most properties. And again, we look for local issuers with a combination of commercial, industrial and residential property tax bases to reduce reliance on the health of any one sector. Therefore, because of the stability of the property tax stream, we do not expect to see a drastic change in the credit strength in municipal issues that are held by our clients.

As for states, according to *The Fiscal Survey of the States*, just published in June 2008 by the National Governors Association and the National Association of State Budget Officers:

Revenues from all sources which include sales, personal income, corporate and all other taxes exceed expectations in fifteen states, are on target in fourteen states, and are below expectation in twenty states. This is a contrast to the previous year where only eight states reported revenue collections lower than estimates.

The revenue reduction is certainly not good news and states are also expected to borrow more, to fund pensions and other retirement obligations. Countering this negative trend is the strength of state balance sheets, built up over several years of strong economic times. State fund balances are projected to decline to approximately 7.5% of state budgets, which is modestly above the 5.8% average for the past thirty years. Contrasting today's state budget conditions with those of several years ago, when state governments faced dramatic declines in personal income tax receipts, states still have reasonable cushions which will probably be tapped to some extent to maintain programs. Chart 3 below shows the total state fund balances over the thirty year period. During the most recent fiscal downturn, in 2003, fund balances were 3.2% of expenditures compared with the thirty year high of 11.5% in 2006.

**Chart 3: Total State Year End Balances**



Source: Fiscal Survey of the States, June 2008

### Kentucky vs. Davis

The last important event this quarter was the affirmation by the US Supreme Court of the status quo for in-state tax exemption for municipal bonds. Kentucky vs. Davis was widely followed by the market, and even though the outcome had been predicted by many, it was still a relief to a market focused on bond insurer downgrades and questions about how state and local governments will deal with consequences of the housing downturn.

### Conclusion

Looking back at what happened in the first half of 2008, we see major transformations in participants and in the structure of the market. The effects of the housing downturn and the credit crisis will be reflected in state and local credits, and may cause some stress, but it appears to be manageable based on historic trends. The change to global ratings will boost the ratings of most issuers, but they remain the same issuers (unless they become less vigilant about their ratings). And the Supreme Court confirmation of the status quo of tax exemption was a positive and stabilizing sign.

The analysis of credit and bond structure is more crucial today than it has been since the mid-80's. Now, with insurance less dominant, investors with credit expertise are rewarded. We believe that our fundamental credit process of reviewing qualitative and quantitative factors affords us the opportunity to select those solid credits for our clients' portfolios.

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*Data Source: The Bond Buyer, Rating Agency Websites, Fiscal Survey of the States June 2008*

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