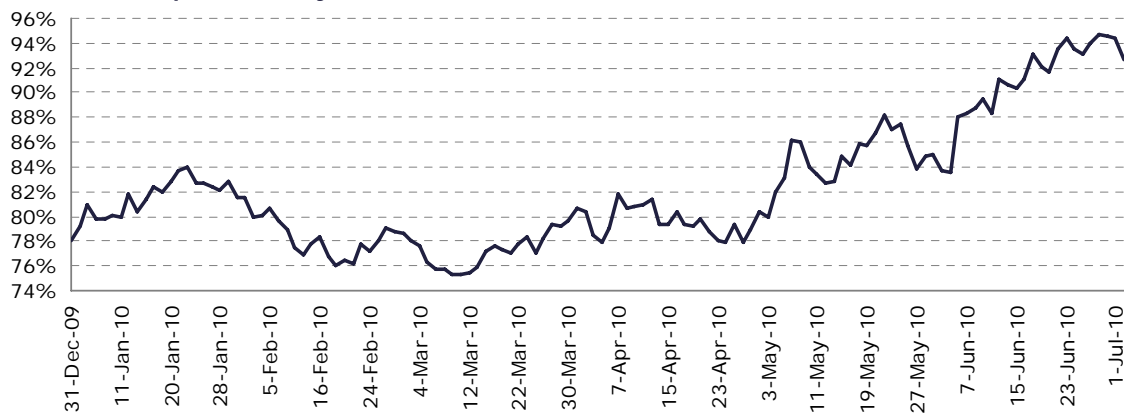


## Why the U.S. States Are Not the Next Greece

The level of concern about municipal credit risk has risen dramatically this year. From a sector that was rarely scrutinized in the main stream media, there has been an unending flood of mostly negative reports and headlines that has caused concern to municipal investors and the public in general. The most frequent media subjects are the comparison of various US states to Greece and the condition of state and local retirement systems and public employee pension benefits. These topics, combined with greater awareness of the decline in tax revenues in a slower economy have caused investors to be concerned about the credit quality of their municipal bonds. The chart below shows municipal/treasury yield ratios since the beginning of this year. An increase in the municipal/treasury ratio indicates that municipals are underperforming treasuries.

**10 Year Municipal/Treasury Ratios**



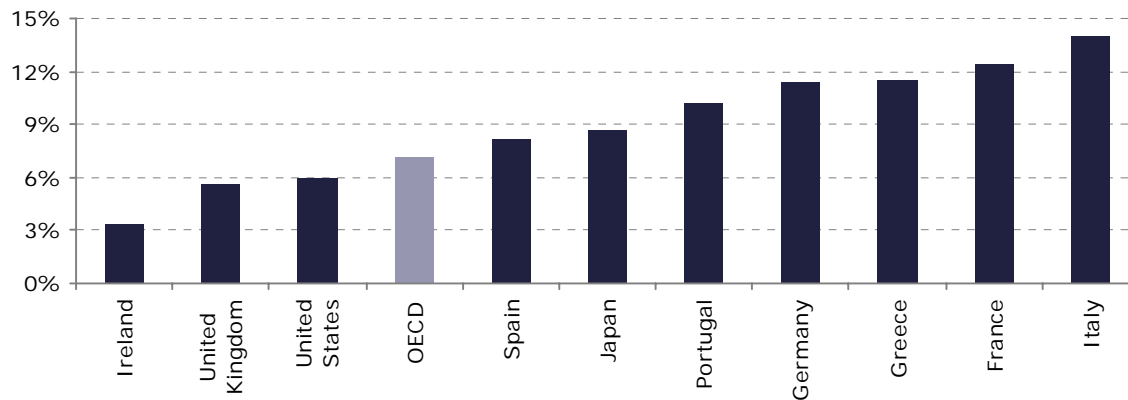
The purpose of this commentary is to parse out some of the psychology facing the market by presenting data without political overtones and by dialing down the vitriolic tone. It is our contention that California and other states are not in the same precarious financial condition as Greece. Trends in US state revenues however, are weaker as economic activity continues to be lower in the aftermath of the 2008 near collapse of our financial system. Changes in resource allocation and spending choices are necessary and will continue for the foreseeable future.

### Greece Compared to US States

The immediate crisis in Greece was precipitated by the near default of its debt this spring. Debt to gross domestic product, an established metric for assessing debt burden, is 113% in Greece. By comparison, the median US state debt to gross state product is approximately 2%. California's debt to gross state product is 3.8% and New York stands at 4.4%. US states have a fraction of Greece's debt burden. Indeed, the median debt service as a percent of expenditures for all US states is just 3%. This is the result of many factors, including state finance laws limiting the amount of debt, the varying capital responsibilities for different levels of state and local governments and the more robust economies that states have on a per capita basis than Greece. Thus, the statement that any US state is the next Greece, meaning a near default on their bonds, is not based on fact.

During the Greek debt crisis much attention was focused on pension payments, particularly as the conditions for the EU loans to Greece involved changes to pension and retirement plans. The level of public pension spending as a percent of GDP in Greece far exceeds that of other OECD countries, and also that of the US (represented by Social Security in the following chart).

### Public Pension Spending as a % of GDP

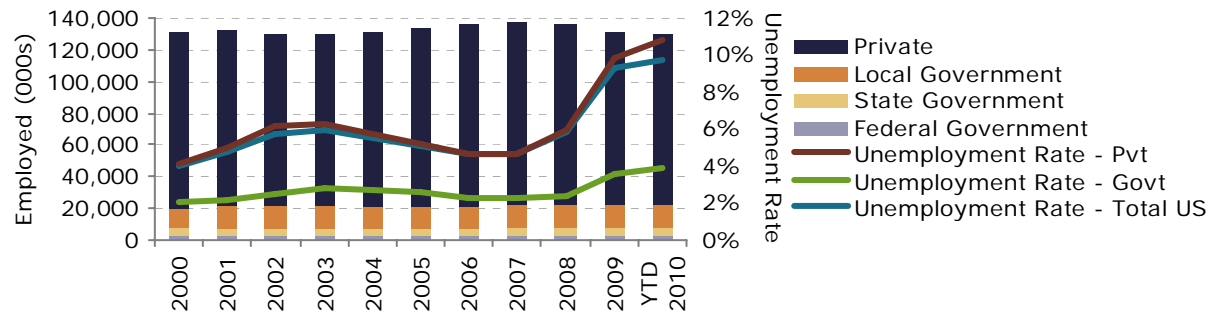


### State Pensions and Public Sector Employment

Inevitably, with comparisons of US states to Greece, and with the scrutiny of state budgets triggered by the recession, there was a greater focus on the financial health of US state and local pension plans. Underfunded pension plans have been a municipal credit factor for years, but there has been more attention recently due to poor investment performance and concerns that actuarial discount rates are too high given the recent weak market environment. Putting aside the anecdotes about public employees getting outsized pensions and retiring at early ages, we analyzed types of pensions, employment and unemployment in the public and private sectors, and examined trends in pension contribution amounts, unemployment numbers and wages. We found the following:

- According to the 2009 National Compensation Survey 84% of state and local government workers had access to traditional defined *benefit* plans, compared with just 20% of private industry workers. Conversely, only 17% of state and local government workers participated in defined *contribution* plans during that year compared with 43% of private industry workers. The non-public employee has seen the traditional defined benefit plan replaced with self directed defined contribution plans such as 401Ks, many of which have been subject to negative market volatility in the past few years. Public employees at the state and local level have been more shielded from the volatility of the markets because of the nature of the defined benefit plan. Meanwhile, the requirement to make payments remains, so if investment earnings are down at the state pension level, the state and local governments have to make up the required difference with taxpayer dollars.
- For new employees, some states are adopting defined contribution plans and changing retirement ages.
- GASB (Governmental Accounting Standards Board) is reviewing its standards for public pensions, and in June 2010 issued a Preliminary View document that focuses on accounting and financial reporting issues. While this Preliminary View does not formally change the current standards or propose new standards, and no changes are required of state and local governments yet, the public input that is anticipated will be useful in determining the alterations in pension reporting going forward.
- Unemployment rates in the public sector are consistently below those of the private sector. Employment at the government level has not been as negatively affected during the recession as the private sector. As presented in the following chart, the unemployment rate for government workers is 3.9% which is approximately a third of the 10.8% unemployment rate of non-government employees.

### Average Number of Employed Workers and % Unemployed (Government vs. Private)



- Average hourly wages also favor public sector workers. State and local government workers, according to the 2009 National Compensation Survey, had median hourly wages of \$21.43, compared with private industry workers median hourly wages of \$15.50.

### Challenges of the States

The biggest challenge that states face is not debt but rather balancing operating budgets. As noted above, changes in pension funding, a lower unemployment rate and higher hourly wages argue for state and local governments' ability to cut expenses over time. During a recession there is greater political fighting for scarce financial resources. With economically sensitive tax revenues declining (personal income, sales and corporate income tax), any additional monies for pension funding from general state revenues will come from education, health, transportation or other state programs.

State pension contributions as a percentage of state expenditures are relatively small at less than 2.9% in 2008. With lower investment earnings and more generous benefits this number is likely to be higher this year. It is the scrambling for the marginal dollars that must be paid and the long term concerns about the viability of pension funds that is creating much of the concern.

One of the most important investment themes in today's marketplace will be selecting the stable states, sectors and credits, since the fiscal challenges vary greatly across US state and local governments. For example, Illinois is now in the spotlight as it has done little to solve a significant budget gap and has the worst underfunded pension problem. Illinois joins California as one of two A-rated credits among Moody's state GO ratings. While California remains challenged, it does not appear at this point to require the same kind of short-term funding that raised concerns last year. New York has a relatively manageable budget gap and solidly funded pensions, though it does not have a budget in place as of this date. New Jersey has high pension and debt service burdens, but its governor is serious about returning the state to a more solid fiscal position. The states of Texas, Colorado, Maryland and Virginia remain stronger and better managed.

### Conclusion

Comparing the Greek debt crisis to state and local governments is not valid and is distracting from the real concerns about budgets. Debt service and pension expenditures are manageable and relatively small compared to other state expenditures. However, examining state and local retirement plans is valid. Harnessing the political will and working through the public policy issues and the political process to look at expenditures at all levels is critical in maintaining confidence in a stable market.

Judy Wesalo Temel  
Principal

July 8, 2010

Data Sources: JP Morgan®, Bureau of the Census, Bureau of Labor Statistics (National Employment Statistics Survey), and Organisation for Economic Co-Operation and Development

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