

The State of Municipal Bond Investments

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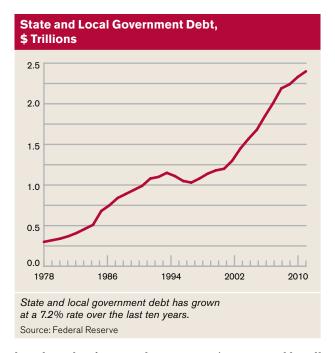
Overview

As today's headlines and credit spreads make clear, state and local governments confront an expansion of fiscal duress. Across the nation, rainy day funds are drawn; employment and wage recovery lags GDP recovery; Medicaid enrollments and pension contributions continue to increase; and local governments are pressuring states for more aid. This commentary provides an overview of Cambridge Trust Company's municipal bond investment strategy. We believe that our investment methodologies will enable us to continue building effective municipal bond portfolios in this challenging climate for public finance issuers.

The Market

According to Standard & Poor's, there are over 90,000 government entities in the United States, many of which have the capacity and authority to issue debt. The entire municipal bond market, including government debt and debt from other issuers, such as utilities, hospitals, higher education institutions and agencies, is estimated to amount to about \$2.7 trillion.

The municipal bond market is broad and diversified, making it difficult to generalize about credit quality. Without question, the recession's reverberations will impact all corners of the vast municipal



bond market for months to come. As reported by all three major rating agencies, the ten-year cumulative default rate through 2009 is 0.04%-0.29% for all rated municipal bonds, including non-investment grade rated debt. Although municipal bonds may experience more defaults than historically low rates, we expect default rates to remain low on a percentage basis. However, the risk of principal loss is still real, as spreads on specific jurisdictions remain wide, emphasizing the importance of research on a credit-by-credit basis.



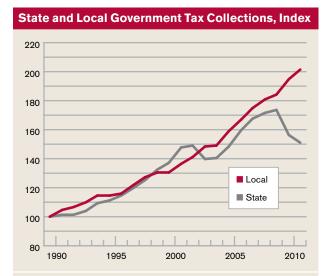
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Our Municipal Bond Investment Strategy Consistent with our investment philosophy, we seek to hold a diversified portfolio of high-quality municipal investments.

Disciplined Research Process: Our portfolio managers and analysts emphasize quality when analyzing an issuer's balance sheet and revenue streams to evaluate whether debt service and other spending requirements will be met within a range of future economic factors. We also consider non-quantifiable (e.g., management) and off-balance-sheet factors, such as the status of pension funding and healthcare expenses.

High Quality: We only purchase issues rated A or better by either Moody's or Standard & Poor's, and the average rating on our municipal bonds is AA. In addition to applying filters based on ratings, we supplement the rating agencies' analysis by conducting our own research to find highly stable bonds backed by strong underlying credit fundamentals.

Diversified: We build diversified municipal bond portfolios. For example, we invest in a mix of municipal bonds backed by both revenues and taxes. Revenue bonds (e.g., water, electric) do not rely on the same pledged revenue sources that states do, such as sales or income taxes. This insulation from primary governmental recessionary forces provides diversification to our portfolios.



Another example of diversification: Local governments are subjected to market forces that differ from states. This chart shows the divergence in tax collection affecting states more than local governments since 2008. Source: Congressional Budget Office

Duration: We carefully take into account systematic economic risk that may adversely affect performance. Based on historically low interest rates, we construct our portfolios with an average duration lower than that of our market benchmark. Following the recent extension of the Bush tax cuts, the rise in interest rates enhanced the relative performance of those shorter-term securities.



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The Massachusetts Economy and Municipal Bond Market

At a presentation to the Regional and Community Bankers Conference on October 21, 2010, the New England Public Policy Center at the Federal Reserve Bank of Boston expressed the opinion that, while states will not immediately feel the fiscal impact of any national economic recovery, Massachusetts is better positioned to withstand the challenges facing states across the country. The Commonwealth's economic strength is anchored in higher education, technology, and healthcare, and heavily exposed to emerging markets such as biotechnology.

Despite its diverse economy, Massachusetts and communities within the Commonwealth face significant challenges. The state faces an estimated \$1.5–\$2 billion budget shortfall in fiscal 2012 (July) when approximately \$1.5 billion in federal stimulus funding will no longer exist. Massachusetts' debt burden is high compared with that of other states with approximately \$17 billion in general obligation debt.

A Focus on Debt Service: Debt service is the annual payment of principal and interest on borrowed funds. Debt service takes a priority status relative to other obligations, strengthening the probability that issuers will satisfy obligations to bondholders in any extreme default situation. Annual debt service represents a small percentage of state budgets, often less than 10%. Massachusetts' debt service levels are about 7% of fiscal 2011 budgeted revenues. Standard & Poor's has estimated that

California would have to suffer a revenue loss of 2.5 times the state average during the Great Depression before its debt service would be jeopardized.

Relative to other states, the debt stability of Massachusetts benefits from a more robust housing market; higher home and consumer prices; higher income, wealth, and education levels; and lower unemployment rates, all positively impacting tax revenue. Revenue streams are diverse, although the state has a high dependency on volatile capital gains.

Unemployment in Massachusetts Declining Faster than National Averages



The Massachusetts Stabilization Fund, at about \$670 million, provides flexibility. Prior to 2010, the sources of this rainy day fund were investment income, .05% of prior-year taxes, funds remaining from the state's budgeted funds, and any legislative-directed transfers. With the approved fiscal 2011 budget, the legislature enacted a policy to



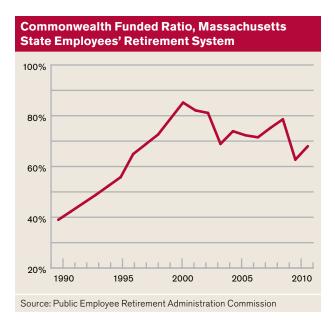




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transfer 95% of capital gains tax revenue in excess of \$1 billion to the Stabilization Fund to build the Fund during strong economic times. (The other 5% will be transferred to the State Retiree Benefits Trust Fund.)

Pension Funding: While monumental pension challenges exist in states such as California, New York, and Illinois, Massachusetts also faces challenges in managing the underfunded status of its pension fund.



Prior to 1990, the funded ratio was less than 40%. It increased significantly in the 1990s, to a high of 85.2% in January 2000, based on multiple factors that included strong investment performance, regular actuarial funding, and a change in the member contribution policy. Despite a significant decline in investment returns in 2008, the pension fund returned 9.3% annualized during the period 1985 to 2009, exceeding projections. As of January 2010, the Commonwealth's funded ratio was 67.5%, with an unfunded pension liability of \$20 billion.

Conclusion

State and local governments must make difficult policy decisions to address fiscal challenges. We believe that Massachusetts is better positioned than many other states to move forward effectively. For example, the cost of insuring \$10 million of Massachusetts debt against default (through a credit default swap) is approximately one-half that of Illinois or California. Although we expect default rates generally to remain low, our investment approach will continue to emphasize quality and diversification as we pursue investment opportunities through the purchase of well-researched fixed-income securities in the highest quality tranches.

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