

## Music to Our Ears

To twice slay the slain,  
By dint of the Brain,  
(Thus Huxley concludes his review)  
Is but labour in vain,  
Unproductive of gain,  
And so I shall bid you 'Adieu!'  
—"Monkeyana" from *Punch*, May 1861

The basic premise from the above stanza satirizing the Evolution Theory is the equivalent of modern day saying of "kicking a dead horse". We often see this move from enlightenment of new information to the rehashing of information that has become commonplace.

After the start of the recession in December 2007, many investors were concerned about municipal funding and potential pitfalls during the next decade. We have seen headlines touting a trillion dollar underfunded pension gap issued in 2009 from metrics taken from the fiscal year end of 2008. Fast forward to today, and one finds that markets have rallied from the near lows made at the time of this report (S&P 500 is up a total of 37% and the Corporate Investment Grade Barclays Index is up 29.6% since 12/31/2008).

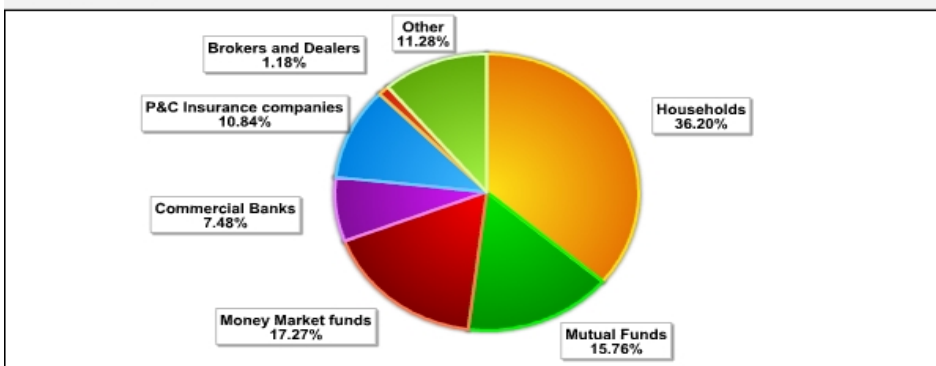
The barrage of negative forecasts for the municipal market seems to be less enlightenment and more scare tactics. These tactics usually are based off of what often inhibits momentum forecasts when markets are already in outlying conditions; extrapolating current metrics as future benchmarks. Now while we have noted that municipals will face some challenges and historic benchmarks of defaults will be tested, there also comes a time when the sky is falling scenarios present rewards that we believe are worth the risks. This requires not only intestinal fortitude, but more importantly, an ability to measure the risks properly.

## Municipal Investors Change Little Over 10 Years

To understand a bit more about the opportunity that has presented itself, we must look at the holders of the municipal market and what little but significant changes have happened over the last decade.

### Municipal Holders: 2001 \$1.6 Trillion total

Source: Fed Flow of Funds



Matthew Lloyd  
Chief Investment Strategist

### In This Issue

**Municipal Investors Change Little over 10 Years**

**Rewarding Ratios**

**The Budgets: Past, Present, and Projected**

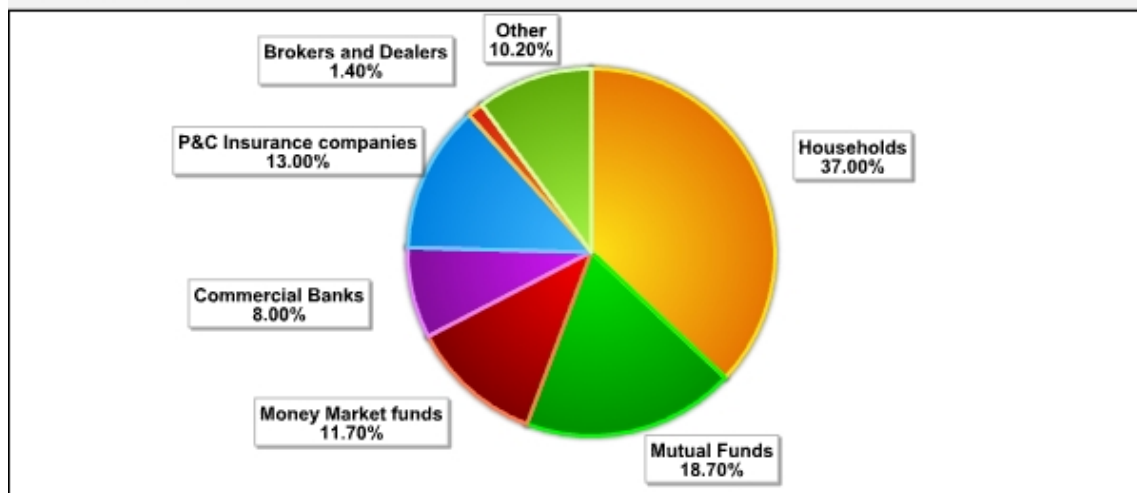
**The Politics of Dancing**

**Historical Defaults and Rating Transitions**

Advisors Asset Management is a SEC registered investment advisor and member FINRA/SIPC. All rights reserved. Copyright © 2011.

## Municipal Holders: 2010 3q \$2.86 Trillion total

Source: Fed Flow of Funds



By comparison, very little has changed except for a few areas. The biggest change is the size of the marketplace that grew from \$1.6 trillion in 2001 to nearly \$2.9 trillion by the end of the third quarter of 2010. By year end however, the total market rose to \$3.2 trillion as the fourth quarter saw one of the heaviest supply of new issues. The combination of heavy supply, worries about Build America Bond subsidy extension, and a rising concern about underlying health saw yields rise dramatically in the fourth quarter.

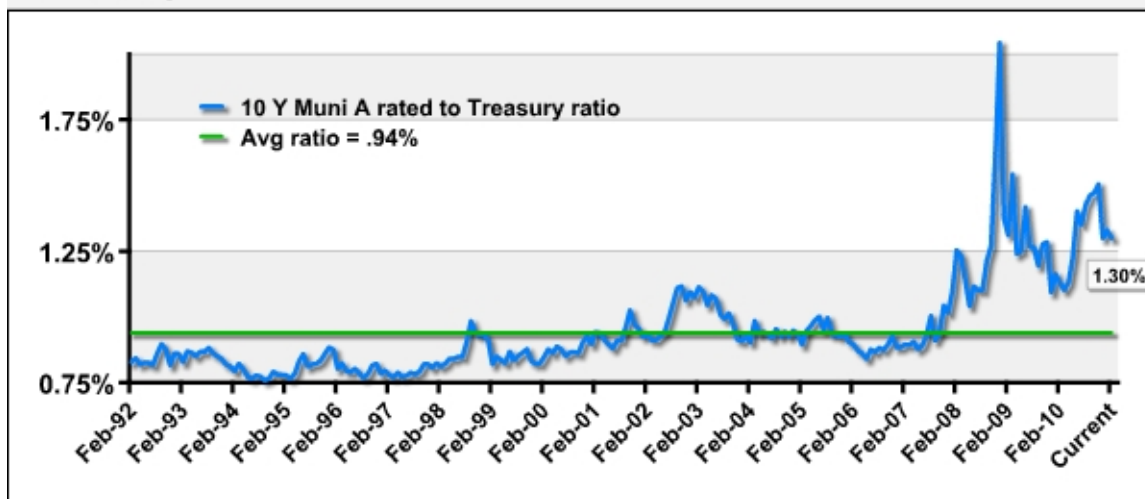
As such, the holders as of the third quarter 2010 created much of this value as individuals and municipal funds sold into an already shaky market. As noted below, we feel that the opportunities for the value investor are at some of their most attractive levels.

## Rewarding Ratios

To measure the degree of the sell off, municipals are often measured as a percentage of Treasuries versus a spread (difference in yields) as seen with taxable issues. This chart shows the yield of an A-rated General Obligation 10-year maturity (Bloomberg index) as a percentage of the 10-year Treasury rate. The average over the last 18 years is 94% and the current rate is 130% which is at some of its widest (most rewarding) during that time frame.

## A- Rated Muni vs Treasury Ratio

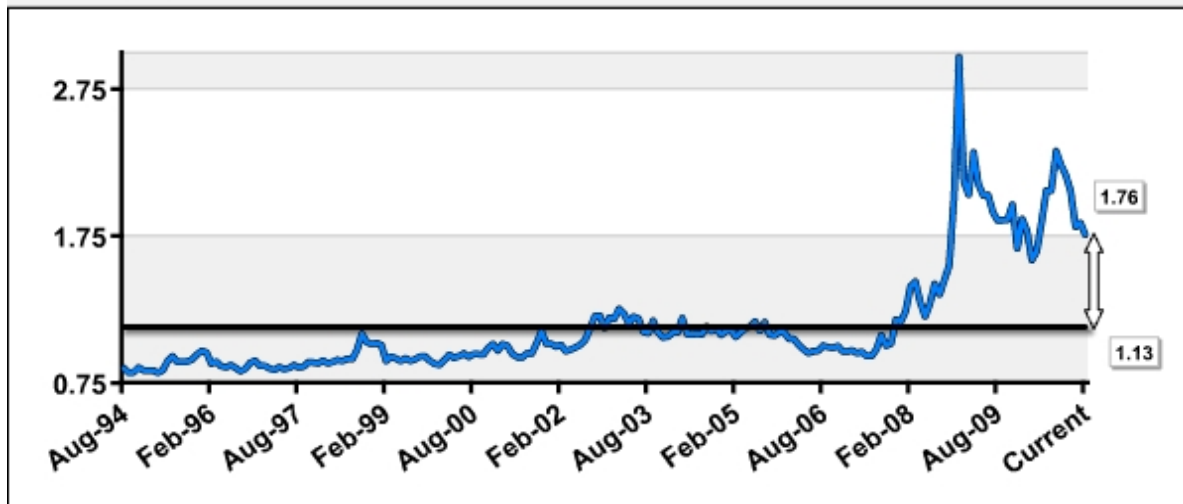
Source: Bloomberg



For those who are willing to take on a bit more risk, the BBB-rated generic revenue bond 10-year maturity may be even more appealing. The current percentage of Treasuries is at 176% while the average is 113%.

### BBB rated Generic Rev % of 10 Year Treasury

Source: Bloomberg

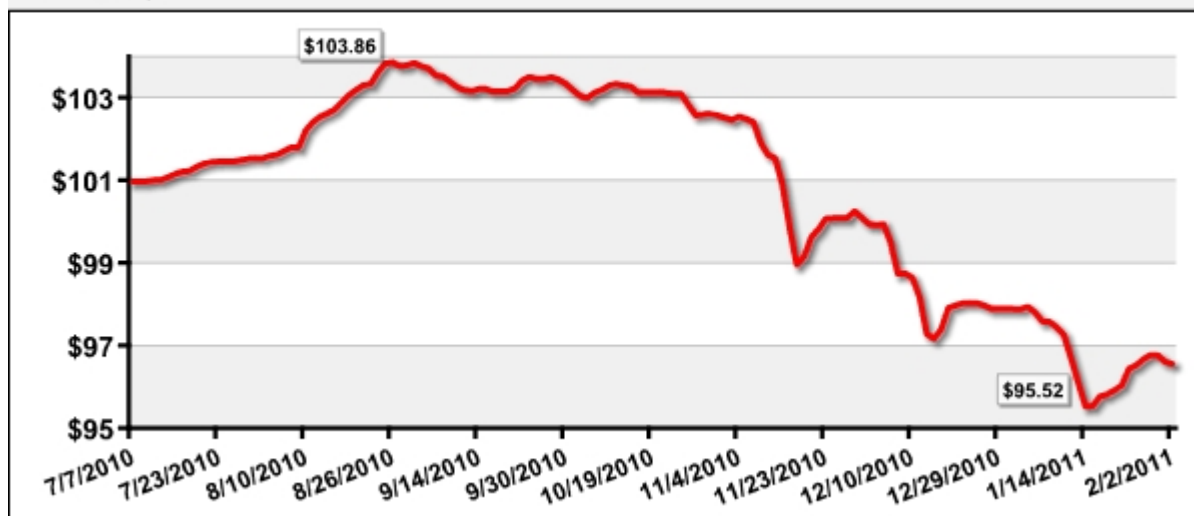


What should be noted is that the two high points of both charts occurred in December 2008 when the 10-year Treasury was at its lowest level in the last 65 years. With such a low rate (2.05%), it exacerbated the ratio and the rate has risen to a current level of 3.48%. In our opinion, it appears that no matter how you slice it (and so long as you conduct the proper credit work or have resources to assist in these areas), there is value to be had in the municipal arena.

For a further reference in the potential value in the municipal area, consider what the price has done on Barclays Municipal Index that comprises over 42,000 issues. The high and low are noted.

### 6 Month Price Change Barclays Municipal Bond Index

Source: Barclays

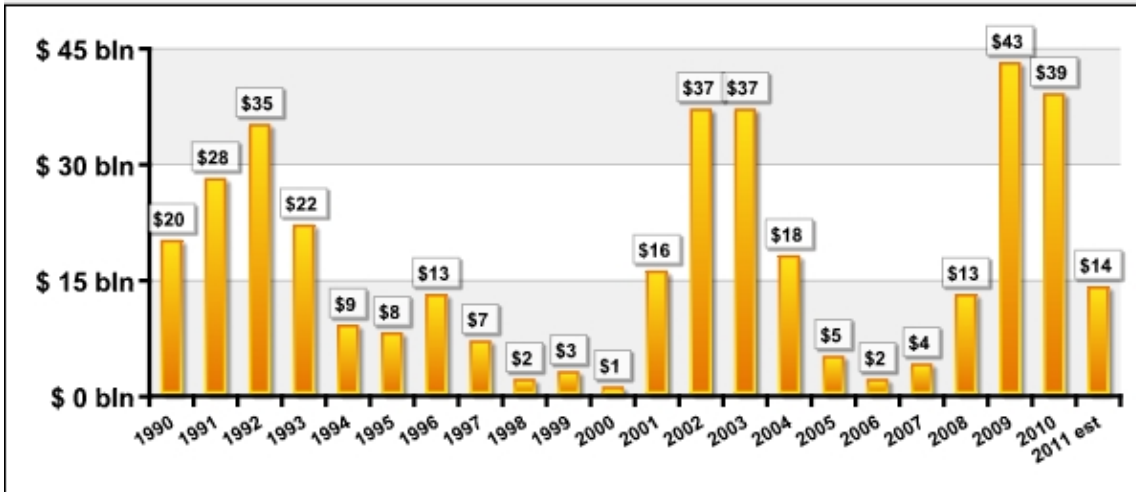


## The Budgets: Past, Present, and Projected

Perhaps the biggest challenge to assessing value is to review the cumulative impact on the budgets from the Great Recession and determining whether projections going forward are too rosy, too pessimistic or just right. Consider the following level of what happens to budgets after they are passed.

### State Budget Cuts after Budgets Passed

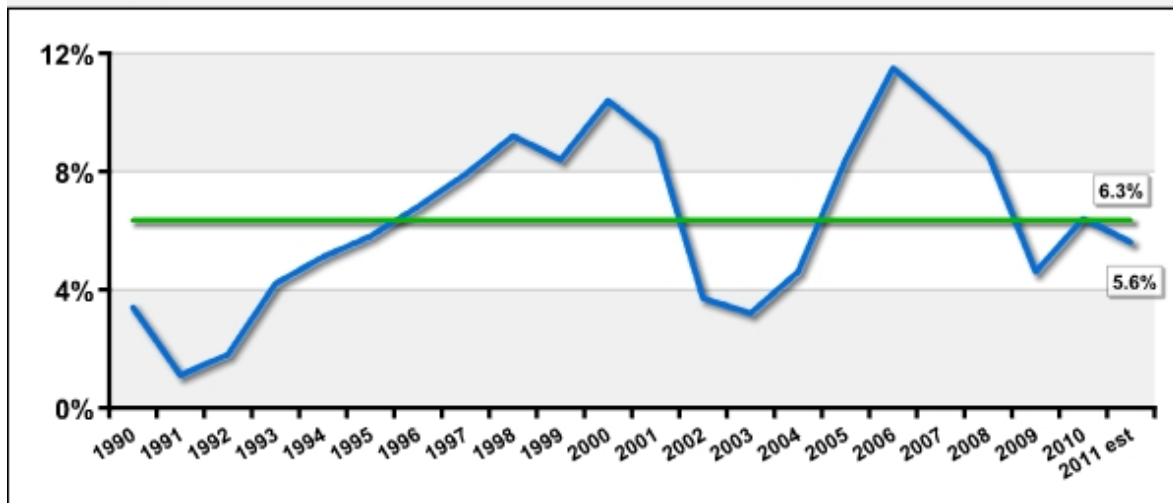
Source: NASBO



- When budgets are initially passed, they always have some sort of cut coming no matter if the economy is growing or receding. Does anyone wonder why voters are so skeptical of elected officials when it comes to finance?
- Two years after the end of the recession has often shown the biggest budget cut prior to the last recession. In the current recession, the largest budget cut actually occurred in the year that the recession ended. Could we be actually a bit ahead of this issue versus the reactive stance taken historically?
- The estimated budget cut of \$14 billion feels like it could at least double to more than \$28 billion if we compare to historical trends and take into account the severity of the last recession in comparison to earlier contractions.

### Total Year End Balances % of Expenditures

Source: NASBO



The rainy day fund as a percentage of expenditures is actually near the historical trend. In all fairness, this number is skewed by two outliers in that Alaska has \$10.5 billion and Texas \$7.7 billion. They comprise 65% of the cumulative total of the states' rainy day fund. Estimates are for the states' general fund to drop from \$13.9 billion to \$10.8 billion by the end of 2011.

As we have noted in the past, we feel the skepticism of projections from government has been justified. However, we should note the dramatic shift in what projections are expected for 2011 versus actual results for 2010 for an increase in general fund expenditure.

### General Fund Expenditure Growth 2010 and 2011

Source: National Association of State Budget Officers "Fiscal Survey of States" Fall 2010

Spending Growth	Number of States	
	Fiscal 2010	Fiscal 2011
Negative Growth rate	45	15
0 – 4.9%	3	18
5% - 9.9%	2	11
10% or greater	0	6

The optimism may be a bit exaggerated, however even a slight hit ratio of their projections display an improving picture—a scenario that is not priced into the market in our opinion.

## The Politics of Dancing

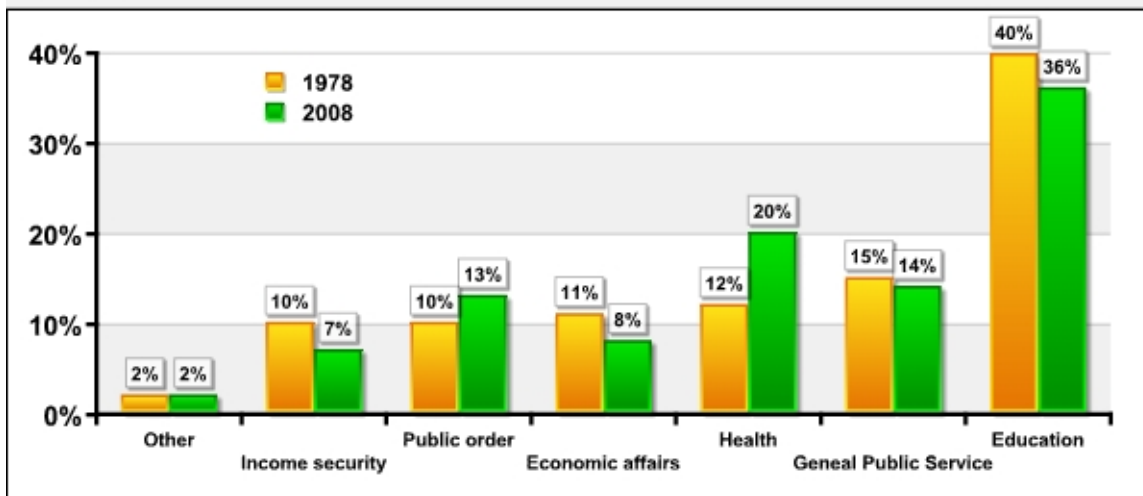
Dare we step out into the more teetering of ledges when we delve into the issue of politics and state finance? It seems that the distinction between the two is as slight as ever.

Recently, *The New York Times* reported that there are proposals to allow states to file bankruptcy for debt relief. This shook up the market. For those looking for a bit more detail on this, I recommend an article written in late January by Scott Colyer, CEO and CIO of AAM. The article is titled "State Bankruptcy Fantasies" and is available at <http://www.aamlive.com/blog/201101/state-bankruptcy-fantasies/>.

To see why allowing states the ability to file for bankruptcy, consider the dramatic shift in state and local expenditures from 1978 to 2008.

## State and Local Expenditures

Source: GAO



What jumps out is the significant increase in health care from 12% to 20% of total expenditures. As it has increased dramatically, it has put pressures on the push back for municipalities and states towards unions with regard to pension benefits and various legacy costs.

Now to put the conspiracy hat on for a moment, we already see the by-product of the enormous amount of pressure towards repealing the Health Care bill from the mid-term elections. Another point of contention is the union's influence with regard to the White House. Letting a state file for bankruptcy allows a bigger bargaining chip with these unions. However, this appears to be semantics, as Mr. Colyer noted in the article referenced above, *"At the present time all municipalities, except for states, have the ability to seek financial reorganization under Chapter 9 of the U.S. Bankruptcy Code. That means that roughly 99% of all municipalities currently have the ability to file for so called bankruptcy."*

## Historical Defaults and Rating Transitions

Moody's released a historical study about municipal defaults, recoveries and rating transitions from 1970 to 2009 (*Special Comment: U.S. Municipal Bond Defaults and Recoveries, 1970 – 2009 - February 2010*). Though we believe there will be several strains to these metrics over the next few years, we feel it provides us with a framework. It is important to note that we do see elevated levels of stressful conditions, be it defaults or headline risk, and that is where we start our analytical process.

Some points of interest from the Moody's report:

- Of the 54 total defaults, 51 were non-general obligation defaults. The average one year default rate for all municipals was 0.1% while corporate defaults stood at 1.57%.
- Defaults since 1970 by purpose: 21 housing, 21 health care, 3 electric/water/sewer, 1 education, 1 recreation, 4 non-general obligation (city, town, county) and 3 general obligation
- The average ultimate recovery of defaulted municipals is 67cents on the dollar while the median recovery is 85 cents on the dollar.

Credit ratings have rightfully come under careful inspection considering the lag and lack of scrutinizing ratings under more stressful conditions. Below is a table of 1-year credit rating transitions from the perspective of single A, BBB and BB-rated municipals from 1970 - 2009. (Caa – C and Withdrawn ratings and have been omitted.)

From/To	Aaa	Aa	A	Baa	Ba	B
<b>A</b>	0.05%	1.34%	94.67%	0.78%	0.01%	0.01%
<b>Baa</b>	0.14%	0.10%	2.27%	92.65%	0.34%	0.04%
<b>Ba</b>	0.04%	0.34%	0.31%	5.94%	83.64%	2.72%

*Source: Moody's: Special Comment: U.S. Municipal Bond Defaults and Recoveries, 1970 – 2009 - February 2010.*

This chart shows that rating transitions are not very common and one should take note if a downgrade occurs. For comparison purposes, corporate ratings are more fluid, to the tune of changing from the original rating by 7% points less. For example, corporate A-rated issues maintain their same A-rated status 87.05% of the time versus A-rated municipals that maintain the same rating at a 94.67% rate. This difference in rating fluidity may only become more of a thorn in the side of credit rating agencies should we hit a black swan event with municipalities.

## Conclusions

The large amount of newly issued debt in the municipal markets combined with the calls for Armageddon and increased cynicism for elected officials has created an intriguing opportunity in our eyes. As we noted in our **10 Themes for 2011 Investment Outlook**, our top theme for this year is municipals and lower grade corporates.

Being a contrarian investor does not necessarily mean one buys when prices drop. Assessing opportunities requires acknowledging that there are usually some kernels of merit for the mass amount of aversion toward an asset. There does come a point however when the value exceeds the risk. We believe that the anthems of opportunities often have the same rhythms and may sound eerily similar to the most underground punk bands. However, keeping ones ear in tune for opportunity may sound like a crisis to most. The late comedian George Carlin may have said it best; "Those who dance are considered insane by those who cannot hear the music".

See Page 8 for important disclosures.

Matthew Lloyd  
Chief Investment Strategist

18925 Base Camp Road  
Suite 203  
Monument, CO 80132

Phone:  
(719) 488-6140

Fax:  
(719) 488-6215

E-Mail:  
mlloyd@aam.us.com

---

INVEST Financial Corporation (INVEST), member FINRA, SIPC, a registered broker dealer, and registered investment advisor, is not affiliated with Advisor's Asset Management or Fixed Income Securities, LP. Securities, advisory services and insurance products offered through INVEST and its insurance agencies are \*not insured by FDIC or NCUA\* not a deposit or obligation of, or guaranteed by any bank or credit union, subject to risks including the possible loss of principal amount invested.

Past performance does not guarantee future results. Prices and yields quoted are subject to change. INVEST, its affiliates and subsidiaries, or their officers and employees may from time to time acquire, hold or sell securities or other derivatives related to such securities mentioned herein. Research report produced by Fixed Income Securities, LP. INVEST has not independently verified this information. This report is not an offer to sell or a solicitation of an offer to buy any security. This report is prepared for general circulation and is for general information only. It does not have regard to the specific investment objectives, financial situation and the particular needs of any specific person who may receive this report. Investors should seek financial advice regarding the suitability of investing in any securities or investment strategies discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Investments involve risk and an investor may incur a profit or a loss. Additional information is available upon request.

---

This report is provided for information purposes only and does not pertain to any fixed income security product or service and is not an offer or solicitation of an offer to buy or sell any product or service. Unless otherwise stated, all information and opinion contained in this publication were produced by Advisors Asset Management, Inc. (AAM) and other sources believed by AAM to be accurate and reliable. Due to rapidly changing market conditions and the complexity of investment decisions, supplemental information and other sources may be required to make informed investment decisions based on your individual investment objectives and suitability specifications. All expressions of opinions are subject to change without notice.

All AAM employees, including research associates, receive compensation that is based in part upon the overall performance of the firm. AAM may make a market in or have other financial interests in any given security with which this analysis suggests may be benefited from its conclusions. Investors should seek financial advice regarding the appropriateness of investing in any security or investment strategy discussed or recommended in this report and should understand that statements regarding future prospects may not be realized. Past performance does not guarantee future performance.

**\*Chart/Graph Disclosure:** This chart/graph does not reflect past or current recommendations made by AAM, should be considered an academic treatment of empirical data and should not be used to predict security prices or market levels. Any suggestion of cause and effect or of the predictability of economic cycles or investment cycles is unintentional. Strategic Times was created using empirical research and analysis by highly experienced market observers and is designed for educational purposes only. This presentation should only be considered as a tool in any broker's, dealer's or advisor's investment decision matrix. Investors should consult their financial advisor when applying the assumptions of this chart/graph.