MUNICIPAL BOND DEFAULT RISK WAY OVERBLOWN

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With debt levels of many governments around the world at high levels and several states and municipalities also struggling to contain their borrowing, the venerable *60 Minutes* thought a discussion about fiscal stresses might make for notable TV. They were right. They brought a guest named Meredith Whitney on the December 19th broadcast and struck TV gold with the following exchange:

"There's not a doubt in my mind that you will see a spate of municipal-bond defaults," said Whitney.

"How many is a spate?" asked correspondent Steve Kroft.

"You could see 50 sizable defaults, 50 to 100 sizable defaults, more," replied Whitney. "This will amount to hundreds of billions of dollars' worth of defaults."

The *60 Minutes* program was the third-most watched show of the week, according to Nielsen Co. ratings. Whitney was chosen for the show for her relative prominence. She had been a contributor on Fox News from 2003 to 2007 and became a bit of a media darling by predicting Citigroup Inc.'s 2008 dividend cut. A *Fortune* magazine interview called her "the superstar analyst."

Whitney accepted the invitation in no small part because she is launching her new research firm. She wants to compete with other ratings agencies like Standard & Poors and Moody's. This was great publicity for her.

After the *60 Minutes* appearance though, enough people were rattled by her comments that some started dumping municipal bonds and smaller investors began pulling money out of municipal bond funds at such a pace that some fund managers had to sell bonds to meet the redemption requests. These motivated sellers sent prices down.

Two days after her interview on *60 Minutes*, in an appearance on CNBC, Whitney put more fuel on the fire and warned of "indiscriminate selling." "It's going to look like Europe in terms of when programs are cut," she said, even using the phrase "social unrest" twice. In the ensuing weeks, net redemptions from muni bond funds totaled $20.6 billion, peaking at $4 billion in the week ended Jan. 19, the most since Lipper US Fund Flows started compiling the data in 1992.

The people most familiar with the municipal bond markets had heard enough. California Treasurer Bill Lockyer called the prediction "apocalyptic arm-waving," the National League of Cities' research director cited her "stunning lack of understanding," and Pacific Investment Management Co.'s Bill Gross, who runs the world's biggest bond fund, downplayed the whole concept.

The *60 Minutes* segment said Whitney and her colleagues spent "two years and thousands of man hours" researching the finances of the 15 largest states. As more municipal experts questioned her experience with municipal finance, her math, and her intentions, Whitney still refused to make her research public. Whitney's firm reportedly charges at least $100,000 a year for its research but copies of the report have leaked out since.

It turns out her report doesn't mention sizable defaults amounting to hundreds of billions of dollars. A person who

has seen a long addendum that profiles the 15 top states said that the longer portion doesn't, either. "We are not calling for any specific defaults within the scope of this report," the document says. An opening summary says there will "invariably" be local defaults but does not elaborate.

Whitney does not have specific numbers backing up her now-famous prediction, she said in a Jan. 30 interview. "Quantifying is a guesstimate at this point," she said. "I was giving an approximation of a magnitude that will bear out to be correct." She added, "A lot of this is, you know it, but can you prove it? There are fifth-derivative dimensions that I don't think I need to spell out to my clients," she said.

That may not strike you as something a “star analyst” would say but it is no shock to us. Perhaps the only thing harder than becoming a star analyst is staying one. One might think the folks on TV know something viewers could profit from but even when the talking heads hit on something, the opportunity doesn’t last. The track record of even someone as notable as Ms. Whitney is dicey at best. Bloomberg News found that about two-thirds of her stock picks since starting her company in 2009 had fared worse than market indexes. Her "single best buy" fell 14% and one of her urgent sells subsequently tripled. "Those are not fundamental calls," she said in the Jan. 30 interview. "I never give myself credit."

Keeping tabs on all the predictions isn’t easy. Before *Fortune* dubbed her a star they also ran a 2008 cover story in which they ranked Whitney 1,205th out of 1,919 equity analysts the previous year, based on stock picking. The magazine said that "evaluating Whitney solely on the timing of her buys and sells misses the point," because her arguments are interesting.

Huh? The whole point of Wall Street research is to try to improve the buy and sell timing in an effort to beat the market. *Fortune* is the one making an “interesting” argument and missing the point.

So where does that leave all of us who like the tax-free income municipal bonds offer? Should we be scared? In our opinion, absolutely not. It is reasonable to have concerns about the fiscal health of municipalities, but abandoning municipal bonds all together is not at all warranted. Default or credit risk is manageable and we do manage it.

Even if states that are encountering fiscal difficulties actually cut local aid, it doesn't necessarily mean city and town governments will default, according to several researchers including Christopher Hoene, Director at the nonprofit National League of Cities in Washington. Buying good quality bonds and muni’s is a sound investment.

Municipalities rarely fail to make their principal and interest payments to investors, according to Moody's, which counted 54 bond defaults over a 39-year period in a report last year on securities it rates. More than three-quarters, 42, were standalone housing and health-care projects, while just three involved general-obligation debt, Moody's said.

Since the Moody’s database was formed, the incidences of default on general-obligation debt are very limited and there has not been a state that defaulted. The most famous default is probably the 1994 default of Orange County, California. What is often overlooked when Orange County defaulted was that the court ruled that the debt does not go away. Bondholders of Orange County debt in 1994 did get paid back, but 18 months late. History is not necessarily a guide and today may be different but even the defaults haven’t been wipe outs.

On Nov. 16, a Fitch Ratings report said that even if there are more defaults than in recent years, they will "continue to be isolated situations." It lists reasons like captive tax bases and bondholders' strong claims on revenue for most debt. It adds that "debt service is a relatively small part of most budgets, so not paying it does not do much to solve fiscal problems (particularly as compared to the costs of such an action)."

A headline in Barclays Capital's "2011 Municipal Market Outlook" says, "The Municipal Default Rate Should Not Rise Materially." Even Whitney has altered her stance and is backing off the impending doom of her comments. When asked to explain her *60 Minutes* predictions during a Jan. 12 CNBC appearance, she said her hundreds of billions in defaults call is "not that much," emphasizing the three words, since there is almost $3 trillion in outstanding municipal debt.

That $3 trillion comes due a little at a time over the next four decades, not all at once. One of the best measures of one's ability to meet debt obligations is the ratio of debt service payments to income. The hubbub around Whitney's comments could give one the idea that these ratios for municipal debt are high. According to Robin Prunty, a senior director in S&P's public finance ratings group, speaking at a luncheon sponsored by the Boston Security Analysts Society in mid-January, "We don't feel that US state and local governments are facing a debt crisis where we are going to see widespread defaults." S&P calculates modest state government debt burdens overall with the average debt service ratio sitting at only 4%. That compares to 15% for sovereign governments rated AAA by S&P.

The comparison to sovereign debt is not exactly apples to apples but such a low ratio suggests that it could be alarmist to abandon municipal bonds altogether. Approximately 99% of US public finance debt is rated investment grade by S&P. Eleven states are rated AAA, and most of those have been for decades. Only two states, Illinois (A+) and California (A-), are rated single-A, still investment grade indicating default remains a low probability outcome.

Surely, some municipal issuers will default – it happens every year but the vast majority of them will not. No state has defaulted since the great depression. S&P estimates the number of non-state local entities (counties, cities, hospitals, school systems, special projects, etc.) to be near 90,000. This year we think it reasonable that some of those will default and those defaults will likely get lots of media coverage. However, Whitney's massive default prediction is not likely and strikes us more as a PR stunt. Of that 90,000+, there are surely plenty of sound issuers.

In our view, the default risks are far overblown and generally, this may be a great time to buy, not sell, municipal bonds and well managed bond funds. If you manage risks by diversifying over enough different issuers and stick largely to high quality credits and reasonable maturities, we do not believe you need to fret over municipal bonds. The bigger question left is whether you will hold on to these good holdings or listen to the doomsayers too much, panic, and miss out on reliable tax-free returns.

We will continue to monitor the credit quality of the bonds and bond funds our clients own. What we will not do is let any talking head undermine our broadly diversified, patient and disciplined approach to the financial markets. We have seen too many supposed "stars" burn out to get fooled by such nonsense. Those people are there to help the media boost ratings and sell advertising; they are not there to help you succeed financially. Don't ever forget that important distinction.

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