



# STANDISH

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Tax Sensitive Fixed Income

## Monthly Municipal Market Update

### Market Commentary

*“Municipal bond yields are attractive relative to comparable high grade sovereign debt...”*

#### Municipal Bonds in Lieu of Sovereign Debt

We believe municipal bond yields are attractive relative to comparable high grade sovereign debt, making tax exempt bonds a compelling consideration for investors, including those not subject to US Federal taxes. In addition to attractive yield, municipals offer benefits of:

##### Diversification:

The correlation between US state debt has averaged less than 50% (10 years ending 9/30/11) with respect to global sovereign debt, US corporate or Treasury bonds. Therefore, the addition of US State general obligation bonds is expected to improve diversification, lower risk profile and increase risk adjusted returns to a global fixed income portfolio over the long term.

##### Low Volatility:

Over the last 10 years, long municipal bonds have proven to be less volatile than their US Treasury brethren, exhibiting 65% of the price volatility (Barclays Capital, 10 years ending 9/30/11).

##### Duration:

Municipal debt issuance is concentrated in longer term bonds, thus providing the opportunity to match long term liabilities with stable fixed income investments. Especially with Operation Twist (a Federal Reserve Stimulus Program) taking out 20% of 30 year Treasury debt, US State general obligation bonds provide a diverse selection of long duration assets.

#### Stable Credit Quality

##### Limited purpose:

Municipal debt is typically issued for a specific capital project whose purpose or use is clearly defined. Many times, voter approval is required in order to issue the debt. Frequently, there is a specific and measurable revenue stream associated with the project which can be used to pay principal and interest on the debt.

##### Structure:

Municipal debt is self amortizing as bond maturities tend to be spread out over a 30 year period using a combination of short, intermediate, and longer maturities. This distribution of debt service defends against “rollover” risk to municipal issuers.

##### Limited scope:

Municipalities are responsible for infrastructure development and upkeep which is considered essential in purpose. These essential services typically have had a long operating history as well as professional management. US States cede responsibility for broad initiatives such as national defense, military, social programs, healthcare, etc to the US Federal government.

##### Low Debt Burden:

US State governments are not highly leveraged and operate within a constrained spending discipline. This is reflected in comparisons between states’ tax supported debt relative to Gross State Product (GSP) as compared to the highly leveraged non-US sovereigns. Incorporating unfunded pension liability within the leverage comparisons only favors US States versus G-20 nations. Source: Moody’s Investors Service & International Monetary Fund, March 2011

##### Contagion:

US States have a pristine record of principal return, and investment grade municipals have a default rate of 0.15% (Source: Standard & Poors Municipal data from 1986-2010). Diversification into US sovereigns limits the contagion effect of a potential Greek default and other distressed sovereign debt in Europe.

The attractive yield of US municipal bonds currently reflects a liquidity premium. The allocation of US State government debt in a sovereign bond allocation needs to consider that the fragmentation and inefficiency of the municipal market leaves it vulnerable to periods where fair execution is difficult to source. However, the high quality, yield, diversification and structural benefits of US state sovereign debt makes a compelling case for inclusion in global fixed income portfolios.

*Thomas C. Casey, Portfolio Manager*

## Credit Observations

*“Credit strengths include the System’s size and regional importance, long history of traffic growth, availability of motor fuel tax revenues in addition to toll revenues, and well maintained facilities”*

### Credit in the Spotlight – Oklahoma Turnpike Authority\*

In October the Oklahoma Turnpike Authority (OTA) issued \$524 million of toll revenue bonds. The Bonds are rated Aa3/AA-/AA- (Moody’s/S&P/Fitch). Bond proceeds refunded a portion of OTA’s debt, both fixed and variable rate. Credit strengths include the OTA’s size and regional importance, long history of traffic growth, availability of motor fuel tax revenues in addition to toll revenues, and well maintained facilities that result in a moderate capital program. Weaknesses include the concentrated nature of Oklahoma’s economy and relatively high (33%), though reduced, exposure to variable rate debt. OTA, which was created in 1947, operates 10 turnpikes with a total of 604 miles of roadway, second only to the New York Thruway in length. Bonds are secured both by a pledge of net toll revenues and motor fuel excise taxes (MFET) collected on OTA turnpikes. OTA has complete authority to raise rates without legislative approval. OTA has raised rates 8 times, the most recent in 2009 by 16%. Traffic, which is 92% cars and 8% commercial vehicles, has increased at a compound annual growth rate (CAGR) of 6.6% since 1985. Toll revenue has increased approximately 39% (3.75% CAGR) since 2001, with only one year of decline, 2008. Approximately 66% of average daily traffic (422,708 in 2010), used electronic toll collection. Debt service coverage, including the available MFET revenues, has been strong and consistent, averaging over 2.0x since 2006. Year to date results, through August, 2011, show traffic and toll revenues down 3.6% and 0.5%, respectively. OTA management attributes this decline to a combination of several bouts of severe weather (snow in Oklahoma and a tornado in Joplin Missouri), volatile fuel prices and the sluggish US economy. Management projects modest revenue growth from 2011 through 2020 (1.9% CAGR) with coverage remaining over 2.0x. The OTA’s consulting engineer considers the condition of the turnpikes to be above average for facilities of similar age. The capital program for 2011-2015 is \$392 million, of which \$206 million will be for paving rehabilitation, \$28 million for electronic toll collection system, \$22 million for concession area development and the remainder for miscellaneous purposes. The Bonds were issued with a yield spread of +51 basis points (10 year maturity) to the Municipal Market Data municipal scale, which we considered attractive for the System’s credit quality.

\* Source: Official Statement Oklahoma Turnpike Authority, Oklahoma Turnpike System Refunding Second Senior Revenue Bonds Series 2011A as of October 5, 2011

*David F. Belton CFA Head of Municipal Research*

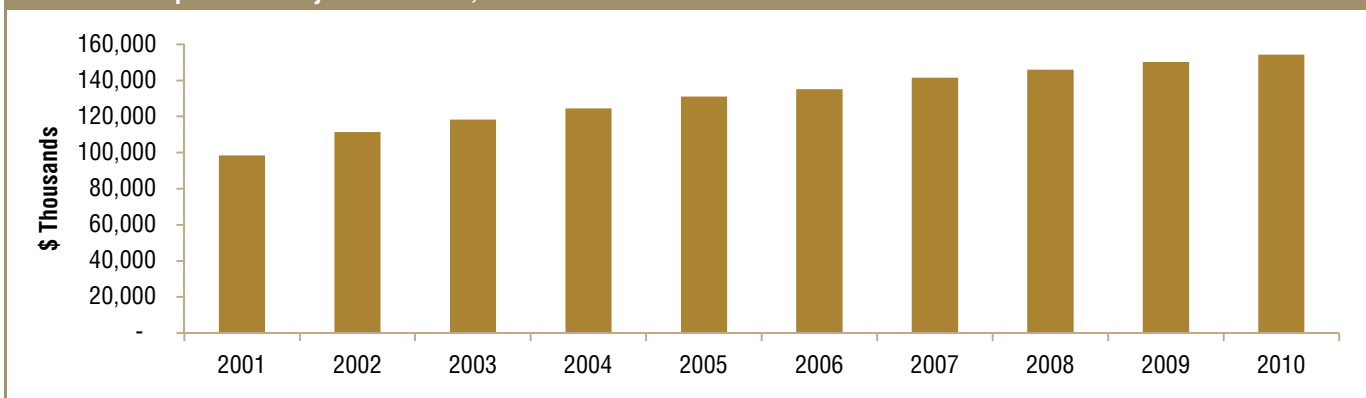
### Other Credit Highlights:

On October 11, The City Council of Harrisburg (PA) voted to file for protection from creditors under Chapter 9 of the U.S. Bankruptcy Code. This action was widely anticipated by municipal market observers due to the longstanding, well publicized fiscal problems facing the City, due largely to its ill-advised guaranty of \$310 million of incinerator revenue bonds. By comparison, the City’s annual budget in FY2011 was \$70 million. It is unclear whether the bankruptcy filing will be accepted by the bankruptcy court. Harrisburg’s mayor opposes the filing; also, the Commonwealth of Pennsylvania has enacted a law that would allow it to appoint a receiver to operate a distressed city such as Harrisburg. There will be a hearing November 23rd to consider the filing and the challenges to it. While there will likely be a significant media attention focused on Harrisburg, we consider the City’s problems very distinctive due to the incinerator bond guaranty and not a bellwether of municipal credit trends.

*David F. Belton CFA Head of Municipal Research*

## Credit Chart of the Month

Oklahoma Turnpike Authority Transactions, 2001-2010



Source: Oklahoma Turnpike Authority 2010 Comprehensive Annual Financial Report, published April 30, 2011.

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