

INVESTING IN MUNICIPALS

Eagle Asset Management offers perspectives on the current municipal bond market environment, ways to help avoid default risk and metrics to use when assessing municipal risk.

EXECUTIVE SUMMARY

- State and local leaders will need to work diligently to find new sources of revenue to fill budget gaps and make deep cuts to reduce spending.
- The economy has begun to show signs of a slow-paced recovery but municipalities are not likely to find relief anytime soon.
- Municipalities face strained budgets but they are still a viable investment alternative because of their ability to raise revenue and cut expenses.

INVESTING IN MUNICIPALS

Municipal bonds are deemed one of the safest categories, but they do have some risks. Given the current economy, the historically low default rates of municipal issuers will likely increase. Safe sectors may not see widespread defaults, but it is believed there will be an uptick in the extremely low historical default rates of the municipal market.

The majority of defaults will likely occur in below-investment-grade bond issuers and among risky sectors such as land secured, housing, retirement communities and special project bonds. Increases in defaults also may be seen among small healthcare issuers that have high bad-debt expenses or rely heavily on Medicaid, that cannot adjust to healthcare reform measures and do not consolidate with larger healthcare systems. It is very important during this time to understand what you own by reviewing the official documents, financial statements and current developments related to the bonds.

States and Local Governments

Decreased tax revenues and higher payments related to programs like unemployment and pension funds have many states and local governments facing extreme budget pressures. Budget negotiations may be more difficult as these governments have already made the easier reductions and now face the end of federal stimulus money. State budget deficits total \$127 billion through 2012 and municipalities lag an economic recovery by two to four years, so steady improvement in revenues will not be available to close the gaps. However, it is important to note that states will continue to fund the shortfalls through a series of expense cuts and increases in revenues through higher taxes or user fees. At a minimum, the states will continue to pay bills that are constitutionally, court or federally required.

States and local governments with large exposure to real estate, manufacturing (especially auto manufacturing), tourism and financial services may face many more challenges and potential downgrade risk. These include, but are not limited to, California, Michigan, Nevada, Arizona and Ohio. Certain local areas within the states may be better or worse than the state as a whole. Credit quality is a case-by-case basis and it is important to look for strong management teams with low debt burdens and strong fiscal reserves. States that have weathered the

recession well include Texas, Iowa, Nebraska, Colorado and Utah.

Credit Outlook

Over the coming months, Eagle Asset Management does not expect to see material improvements in the fundamentals of the municipal market. The economy has begun to show signs of a recovery at a slow pace, but municipalities are not likely to find relief anytime soon. Certain sectors such as water and sewer, transportation and higher education may encounter improvements sooner than municipal issuers of general-obligation debt, which will likely continue to face hardship over the next two years. Tax revenues that support many municipal bonds typically lag a recovery by two or more years.

State and local leaders will need to work diligently to find new sources of revenue to fill budget gaps and make deep cuts to reduce spending. Eagle is confident they will meet the challenge but not without strong arguments along party lines, potential protests and strikes from government workers and continuing negative media attention. Eagle does not believe the fiscal challenges will lead to widespread municipal defaults as some articles suggest, especially in the sector bonds Eagle strives to invest in.

Know What You Own

Municipalities face strained budgets but they are still a viable investment alternative due to their flexibility to raise revenue and ability to cut expenses. Debt service is typically less than 7 percent of total operating expenses and is a top priority for issuers. After education funding, debt service is usually next on the hierarchy of payments because municipalities demand continued access to capital markets.

The risk of default exists; however, there are ways to protect against it. Most importantly, understanding

what supports repayment of particular bonds, including consistent revenue streams, low debt burdens and strong fiscal reserves.

Eagle attempts to mitigate default risk by:

- Focusing on bonds issued by municipalities in areas with smaller budget gaps, lower foreclosure and unemployment rates and significant reserve funds, as well as, essential service revenue bonds.
- Maintaining approximately 5 percent position sizes and emphasizing geographic diversification to ensure a portfolio is not subject to the concentrated risks of a particular issuer or area.
- Continually monitoring portfolios to determine credit quality. Eagle will sell a credit if it believes the issuer has a deteriorating financial position beyond what all municipalities are facing.

Rating Agencies

In the current environment, investors should not rely solely on rating agencies as their opinions of an obligor's overall creditworthiness may be based on stale and outdated information. Many participants feel the agencies (e.g., Standard & Poor's, Fitch Ratings and Moody's Investors Service) have lost credibility as a result of the swift downgrades of mortgages and bond insurers. Numerous municipal bond investors relied on the AAA rating bond insurers carried. When they were subsequently downgraded, investors were left holding unfamiliar credits that exhibited much lower credit ratings.

In addition, Moody's and Fitch have recalibrated municipal bond ratings to a global scale. The change moved many ratings up 1 to 3 notches, although there were no corresponding improvements in credit quality. This broadens the band of credit quality within each rating category and is another reason thorough credit work is important. That is why Eagle's fixed-income team looks at the underlying credit quality of an issuer to value bonds and produces its own credit ratings analysis, independent of the ratings agencies.

An emphasis on credit analysis helps ensure you are investing in a higher quality bond within a rating category. This has always been an integral part of Eagle's investment process. The effort helps ensure our ratings are accurate, timely and predictive.

Key Metrics to Assess Municipal Credits

- A strong management team is extremely important to assess the credit strength of a municipal issuer because it typically provides stability through economic cycles. It is subjective and may be difficult to assess, but it's possible to glean information from rating-agency reports, news articles (with caution) and track records (e.g. conservative revenue estimates, strategic planning, timely disclosure).

Tax-Supported Debt:

- Demographics of a particular area: Wealthy, higher education levels, lower unemployment rates, growing tax base, full valuation of area per capita (~\$75,000 is median)
- Diversity of revenue streams: Low concentration of taxpayer base, industries supporting area
- Expenditure flexibility: Fixed versus variable costs, mandated costs
- General fund reserves: Trends, availability, liquidity
- Tax-collection rate: 95 percent or higher
- Debt burden

Revenue-Supported Bonds:

- What is the source of revenue and is it viable long-term?
- Debt-service coverage provided by the revenues pledged as security
- Strong market position and ability to set rates
- Link between the local economy's strength and the service area
- Cash-flow ratios such as working capital to assess liquidity
- Debt burden and reserve funds.

For additional information about Eagle's municipal fixed-income programs, please call your financial advisor or visit eagleasset.com.

Please see important disclosures on next page.

Many investors consider bonds to be “risk-free” investment vehicles. Historically, bonds have indeed provided less volatility and less risk of loss of capital than has equity investing. However, there are many factors which may affect the risk and return profile of a fixed-income portfolio. The two most prominent factors are interest-rate movements and the creditworthiness of the bond issuer. The risk of a change in the market value of the investment due to changes in interest rates is known as interest-rate risk. Interest-rate risk is subject to many variables but may be analyzed based on various data (e.g., effective duration). The risk that the issuer may default on interest and/or principal payments is often referred to as credit risk. Credit risk is typically measured by ratings issued by ratings agencies such as Moody’s and Standard & Poor’s. Bonds issued by the U.S. Government have significantly less risk of default than those issued by corporations and municipalities (see below for a discussion of the risk associated with convertible securities). However, the overall return on Government bonds tends to be less than these other types of fixed-income

securities. Finally, reinvestment risk is the possibility that the proceeds of a maturing investment must be invested in a lower yielding security, all other things held constant, due to changes in the interest-rate environment. Investors should pay careful attention to the types of fixed-income securities which comprise their portfolio, and remember that, as with all investments, there is the risk of the loss of capital.

Investment-grade refers to fixed-income securities rated BBB or better by Standard & Poor’s or Baa or better by Moody’s.

Quality ratings are used to evaluate the likelihood of default by a bond issuer. Moody’s Investors Service, or another independent rating agency, analyzes the financial strength of each bond’s issuer. Their ratings range from Aaa (highest quality) to C (lowest quality). Bonds rated Baa3 and better are considered “investment-grade” bonds. Bonds rated Ba1 and below are considered “below investment grade” bonds.

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