

DIVERSIFY ACROSS STATES

JANNEY FIXED INCOME STRATEGY

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Diversification beyond an investor's home state may have a tax cost, but the risk management benefit outweighs this cost.

REMINDERS FROM CATASTROPHE

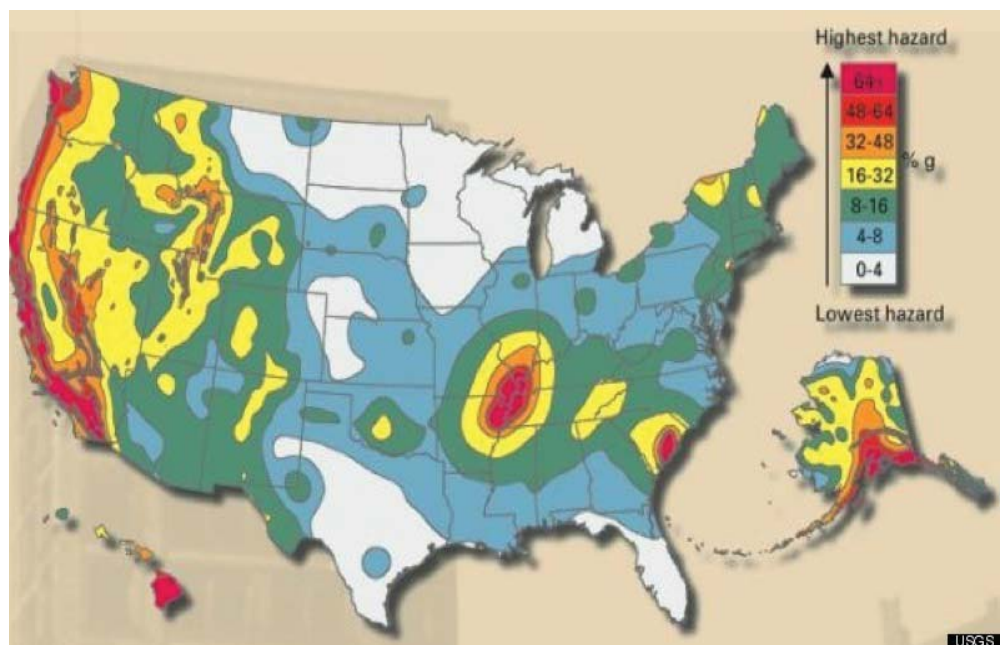
The tragedy of the Japanese earthquake and subsequent tsunami leaves a horrific aftermath of lives lost, homes destroyed, significant, perhaps record, commercial property damage and severe and likely extended economic impairment. The destruction was focused on three prefectures, the rough Japanese equivalent of a state, with damage and death extending to others of Japan's 47 prefectures.

In 2005 Hurricane Katrina hit Louisiana, Mississippi and other Gulf coast locations, with damage estimated at \$125 billion or higher. Radiation leaks from the partial meltdown of unit #2 at the Three Mile Island, Pennsylvania nuclear plant in 1979 were largely contained, with minimal damage beyond the reactor, but the scare was significant. The west coast of the United States and Hawaii are not the only earthquake prone regions of the US, with the nexus of Arkansas, Missouri, Illinois, Kentucky, Tennessee and Mississippi centered on the New Madrid fault line. Coastal South Carolina is also a high hazard area, according to the U S Geological Survey.

The ratings of many Gulf Coast communities were lowered in the months following the hurricane, some to junk status. S&P dropped Biloxi from A to BBB and New Orleans' ratings fell from Baa1/BBB+ to Ba1/B. In time, massive injections of federal aid actually increased economic activity, and buoyed municipal budgets. Most ratings returned to pre-catastrophe levels. New Orleans is now rated A3 by Moody's and BBB by S&P.

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US Earthquake Hazard Zones



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U S Geological Survey

Interestingly, according to the Japanese Local Government Bond Association website, most local municipal issues in Japan are sold as “joint local government bonds.” 35 of Japan’s 49 issuers participate in this regular offering mechanism whereby the participating municipalities “protect bondholders through joint responsibility for principal and interest repayment.” Two of the three most severely impacted prefectures, Miyagi and Fukushima, issue through this joint responsibility system, so in a sense, Japanese investors achieve geographic diversification, since debt service is backed by 33 other prefectures and communities, most of which felt little direct impact from the natural disaster. By the way – Japanese municipal bonds are also tax free, an important feature in a country with a top income tax bracket of 40%.

GEOGRAPHIC DIVERSIFICATION

US municipal bond investors don’t have such a credit diversification option, so it’s important to include diversification goals within portfolio design. There may be tax benefits from owning only munis issued within the state of residence, but they are offset by the increased risk of narrow diversification. As the headlines note, many states and municipalities are under significant fiscal stress. In general, the financial health of a state is one indicator of the creditworthiness of municipal issuers within the state. Last year’s budgets and proposed plans for the coming fiscal year typically included reductions in state aid to cities, counties and school districts. The more stressed the state, the more draconian the cuts. States such as California, which seems to undergo constant political gridlock, in large part due to many voter approved mandates and restrictions, may not be the best area to consider at this point. Illinois, with about \$9 billion in unpaid bills and large unfunded pension liabilities is still struggling to right its ship. New Jersey, second among states in the amount of income per capita, offsets this wealth by being near the top of states in terms of taxes as well as debt and pension liabilities. This is not to say that bonds from these states should be avoided altogether. There are many high quality communities and issuers in each of these states.

To achieve a reasonable level of diversification, we believe that portfolio allocation to an investor’s own state should not exceed 50%. This isn’t necessarily to suggest an overnight change, but investors with a one state portfolio should consider opportunities to swap or replace maturing debt with bonds from other geographic areas. Yes there is a tax penalty, but even after factoring in any state income tax liability on out of state interest, taxable equivalent yields for municipal bonds remain compelling, compared to taxable alternatives.

There are many choices and paths to achieving geographic diversification, but the three states noted below are worthy of consideration. One thing they have in common is lack of a personal income tax, which generally means their taxpayers gain no tax benefit from, and therefore have less demand for in state issues, leading to yields which may be marginally higher, partially offsetting the state tax bite on out of state bonds.

WASHINGTON

Washington has the smallest population among the states noted. Its budget process is biannual, but is adjusted periodically during the two year period. Like other states, Washington has structural budget deficits, but has shown a willingness to quickly adopt changes to bring revenue and spending into balance. The economy is over concentrated in the aerospace industry, but the state has a strong record of managing finances through the cyclicity of Boeing and company.

- State debt is rated Aa1/AA/AA ratings – all with a stable outlook
- Unemployment rate 9.1% (Feb 2011)
- 4.1% population growth past ten years
- Healthy pension funding and above average debt levels put state in middle of pack (25th) in liabilities as percent of GDP (Moody’s)

We recommend that an investor’s allocation to his or her home state not exceed 50% of a municipal portfolio.

The common thread between our three recommended states is the absence of state income taxes, which reduces the yield penalty an investor incurs from buying out-of-state bonds.

- State guarantee on school bond program – voter approved school bonds same rating as state.
- Larger issuers in the state include
 - ▶ Energy Northwest (Aaa/AA/AA) - successor to Wash Pub Pwr Sup Sys (WPPSS)
 - ▶ Seattle Municipal Light and Power (Aa2/AA-) - hydro generated municipal utility
 - ▶ Motor Vehicle Fuel Tax (Aa1/AA/AA) - backed by the tax as well as state's GO pledge
 - ▶ Central Puget Sound Regl Trans Auth (Aa2/AAA/NR) - sales tax revenues
 - ▶ King County (Aa1/AAA/AA+) - centered around Seattle economy

FLORIDA

Florida may seem a counterintuitive choice, given the impact from the state's painful real estate market. From Dec 2005 to Dec 2010, housing values fell by more than 40% in Tampa and Miami, compared to declines of 16% in Seattle, 6% in Dallas and a composite (20 metro areas) drop of 30%. Nevertheless, there are many strong communities in Florida, typically older developed towns and smaller cities, with more stable populations and positive credit metrics.

- State debt is Aa1/AAA/AAA - Fitch has a negative outlook
- Unemployment rate 11.5% (Feb 2011)
- 16.9% population growth past ten years
- Healthy pension funding and moderate debt levels rank state at 31st among states in liabilities as percent of GDP (Moody's)
- Most state GO bonds are self funding. For example state Board of Education bonds are secured by a pledge of part of motor vehicle license tax in addition to being GOs.
- Larger issuers in the state include
 - ▶ Florida Turnpike (Aa3/AA-/AA-) - secured by toll revenue.
 - ▶ Florida State University (Aa2/AA/AA) - one of two flagship state university systems
 - ▶ JEA – Jacksonville Electric (Aa2/AA-/AA-) - 400,000 customers in Jacksonville area
 - ▶ Palm Beach County (Aaa/AAA/AAA) - largest county in Florida and third most populous
 - ▶ Florida Hurricane Fund (Aa3/AA-/AA) - statewide assessments on insurers

TEXAS

Texas is the second most populous state with a variety of issuers, and a wide range of credit profiles. The state economy is very diversified. According to Moody's the state "entered the recession later than most states and has begun to recover earlier." Texas has a large system of municipal utility districts, with taxation and bond issuance authority. They range from established and wealthy communities to developer initiated start up projects, with questionable credit metrics.

- State debt is Aaa/AA+/AAA rated
- Unemployment rate is 8.2% (Feb 2011)
- 20.9% population growth last ten years
- Strong pension funding levels and moderate debt load put state at 42nd among states in ranking of liabilities as percent of GDP (Moody's)
- The state's permanent school fund is strongest program in the country garnering Aaa/AAA/AAA

An effective diversification strategy should include various sectors within the municipal market

rating for school district debt

- Larger issuers in the state include
 - ▶ North Texas Tollway Auth (A2/A-/NR - 1st tier) - toll revenues from 32 mile Dallas highway.
 - ▶ Dallas Area Rapid Trans (DART) (Aa2/AA+) - sales tax backed Dallas area mass transit
 - ▶ Lower Colorado River Auth (A1/A/A+) - wholesale electric in central and south Texas
 - ▶ University of Texas (Aaa/AAA/AAA) - one of largest higher education systems in the country
 - ▶ Dallas-Ft Worth Airport (A1/A+/A+) - fourth busiest airport in US.

CONCLUSION

There are many other bond issuers across the country with a wide variety of credit profiles and ratings to satisfy a variety of investor risk tolerance levels. An effective diversification strategy should also include various sectors within the municipal market. Examples noted include public power issuers, toll revenue, airport revenue bonds and education, both K-12 through state supported programs, and higher education systems. Your Janney Financial Advisor can assist you in developing a diversification strategy which best suits your investment objectives.

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