

# THE FRONT OF THE LINE

## JANNEY FIXED INCOME STRATEGY

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Fiscally challenged municipalities are issuing new types of bonds with enhanced security features. Bondholders get first crack at re-directed revenue streams.

### MOVE TO THE FRONT OF THE LINE

In these difficult economic times, municipal issuers with less than sterling credit profiles are frequently structuring highly secured issues which take first priority on specific revenues, garnering a higher rating and lower interest cost. This class of bonds dates back to Big MAC issues of the 1970's, when, on the heels of a New York City default, the state of New York created Municipal Assistance Corp. (MAC) to help the city survive its financial difficulty. MAC raised funds to give the city breathing room and enable it to get its fiscal house in order. The bonds were secured by a dedicated portion of sales and other taxes collected by the state in New York City. Credit ratings for MAC bonds were high enough to allow a lower interest rate than the city would have paid – if it could have issued bonds at all.

New York City and MAC were successful. Today New York City carries the same ratings as New York State (Aa2/AA/AA) and is known for its strong financial management. The circumstances surrounding each of the issuers we look at are not identical to New York's. For example New York City is the largest city in the country, with a population that continues to grow, while Detroit has had a declining population since the 1950s. Nevertheless, some observable trends are evocative of New York City's original problems. As MAC was a well secured, strongly rated issuer, so too are several of the newer breed we'll look at.

### DETROIT AND PUERTO RICO

Detroit's Distributable State Aid (DSA) bonds, issued in March 2010, carry a Aa3/AA- rating while the city's general obligation debt is junk rated at Ba3/BB/BB+. The DSA bonds are secured by a dedicated portion of Michigan's statewide sales tax. Ironically the stronger credit of the DSA bonds weakens the creditworthiness of the city's outstanding GO debt since it has a senior claim on revenues the city would otherwise receive from the state. Effectively the new bonds move to the front of the line to receive revenue.

COFINA (Puerto Rico Sales Tax Financing Corp.) bonds were issued, beginning in 2007, to refinance certain Puerto Rico appropriation debt, with 2009 legislation expanding the scope to include the funding of Puerto Rico's deficit through 2012. Senior debt is rated Aa3/AA-/A+ while subordinated bonds are A1/A+/A+. These bonds are secured by a carved out portion of the island wide sales tax. Revenues which would have supported Puerto Rico GO debt, rated A3/BBB-, are applied first as security for the COFINA bonds, which therefore are able to move to the front of the line.

Comprehensive Janney reports are available on Detroit and COFINA, with important information on both the strengths and weaknesses of these issuers. Future reports will look at other issuers whose bonds were issued with similar dedicated revenue sources offering stronger security than the issuer's GO debt.

### THE PATH TO DIVERSIFICATION

We've regularly emphasized our belief that municipal investors need portfolio diversification that extends beyond state of residence, despite potential tax costs associated with paying state income tax on interest from bonds issued in another state. (Diversify Your Munis 6-15-10). There are many issues to choose from among the nearly three million CUSIPs of US municipal issuers. We are focusing on this particular type of bonds, largely because they represent stronger credit quality than their associated issuers. The yields available are frequently above those of like rated bonds because of the difficulties experienced by the underlying issuer.

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