

DIVERSIFY YOUR MUNIS

JANNEY FIXED INCOME STRATEGY

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Diversification, a key tenant of prudent investing, is an important, although not necessarily intuitive strategy, for municipal bond investors.

ARE MUNIS SAFE?

Municipal bonds have traditionally been considered one of the "safest" of investment sectors. April actions by Moody's and Fitch seemed to emphasize the generally high quality of municipal issuers when state ratings and many local government ratings were raised in a "recalibration" exercise, bringing municipal ratings criteria and methodologies in line with those used for the debt of corporations and other bond issuers. Historical default rates for municipal issuers have been much lower than like rated corporations, and the few defaults tended to have higher recovery rates than corporate defaults.

The Great Recession and the attendant high unemployment rates have been challenging for state and municipal issuers. Tax revenues have declined, or ceased to grow and budgets are unbalanced. Longer term issues such as unfunded pension liabilities and future growth in Medicaid expenditures have added to the pressure. Articles in the New York Times, Wall Street Journal, Barron's and Time Magazine, among other media outlets, have raised the alarm – are munis really safe?

Our answer is yes. We reiterate our opinion – **while there will be some defaults in the coming years, we do not expect a muni meltdown.** Generally state and local credits remain strong. There are problems. Jefferson County, AL has huge issues. Harrisburg, PA has defaulted on guaranteed debt, and is searching for solutions. Vallejo, CA filed for bankruptcy in May 2008. While these issuers have defaulted, they are but a few in the government sector which includes tens of thousands of issuers. But all being said, it is still important that investors not lose sight of the most basic of investment tenants – diversification. An investor's eggs should be distributed across not just one basket but several.

DIVERSIFY ACROSS STATES

Many municipal investors concentrate their municipal holdings in the state of residence. This is particularly true for residents of high income tax states such as New Jersey, Rhode Island and North Carolina. The intuitive thinking is that if a muni portfolio generates \$100,000 of tax free income, it makes sense to keep it entirely tax free. A top bracket New Jersey resident who owns an entire portfolio of non New Jersey tax free bonds would have to pay \$8,970 in state taxes – a hefty slice of that income. Nevertheless, we believe that a diversification strategy is appropriate and desirable. In this example, diversifying into 25% non-New Jersey bonds would cost about \$2,500 in taxes (perhaps less after factoring in the federal deduction for state taxes paid). Furthermore, due to strong demand from in state residents, bonds from high tax states tend to trade with lower yields than bonds from states with low taxes, so additional yield from bonds issued in low tax states will help compensate for a portion of the income tax bill.

The full impact of the tragedy unfolding in the Gulf region remains to be seen, but a recent review of an all Florida municipal bond portfolio for a client shed light on the vulnerability of having all bonds in one geographic area. And Florida has no state income tax, so the tax benefits were negligible. Natural and manmade disasters can disproportionately impact a large geographic area, but financial or legislative events can also negatively impact a state. Each state has differing approaches to municipal bankruptcy and each offers differing levels of support to local communities experiencing financial difficulties.

Diversification need not happen all at once. A strategy of replacing maturing bonds with different state bonds may be a useful approach. Periodic portfolio reviews are prudent, and such a review may present an opportunity to swap from an in-state bond with weaker credit or yield characteristics into a stronger bond from another state.

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DIVERSIFY ACROSS SECTORS

Our Municipal Bond Market Monthly publication includes our outlook for various municipal market sectors. It's important that a diversification strategy include different sectors. For example, the water and sewer sector is largely based on revenue streams for essential services which are paid for by consumers even in difficult times. Although there is uncertainty in the health care sector, some allocation to higher quality health care issues can achieve diversification as well as yield benefits. Established successful toll roads may lose some traffic when the economy slows, but, if the coverage margin is strong, will continue to pay. Spreading a portfolio across sectors helps to eliminate the potential for an increase in one type of risk - say budget deficit risk at the state level - from impacting all of the investments in a portfolio.

NOT ALL MUNIS

Including non municipal bonds in the overall portfolio is also a prudent component of diversification. Municipal yields, relative to Treasury yields, shot up in 2008 and early 2009, as values dropped sharply. Concerns about auction rate securities (ARS) and municipal insurers tarred all municipal bonds, even though most were not ARS and most insured bonds had strong underlying ratings. Relative yields eventually recovered, but the episode illustrates the benefit of diversification. An IRA, with attendant tax benefits, offers a diversification vehicle. In the absence of an IRA or similar account, an all municipal portfolio should be reviewed, with consideration given to diversifying into non-municipal names (corporate or agencies for example) even though there may be tax costs.

CONCLUSION

We believe the municipal sector continues to exhibit strong credit characteristics, despite the challenges many issuers face in the "new normal" economy. Diversification can help immunize a municipal portfolio, but spreading the risk across several similar issuers isn't enough. Instead, the prudent course of action is to diversify across states, geographic regions of the country, municipal sectors and even into other asset classes. Municipal portfolios will benefit from expansion beyond the municipal sector, even at the cost of less tax free income.

In the absence of an IRA or similar account, an all municipal portfolio should be reviewed, with consideration given to diversifying into non-municipal issues even though there may be tax costs.

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