

# Lazard Insights

## Conference Call Series

15 December 2009

# Summary

## Deconstructing the Municipal Bond Market: Challenges and Opportunities

Featured Speaker: **John Senesac**, CFA, Senior Vice President, Portfolio Manager/Analyst

### Overview of the Municipal Market

The municipal bond market is highly fragmented, as it has the smallest amount of outstanding debt and the largest number of issuers, roughly 6.5 times as many issuers as the corporate bond market. Municipalities also have approximately two million bonds in circulation in the marketplace, while the corporate bond space has approximately 70,000. In addition, relative to the U.S. public corporate market, reporting by municipalities is much more inconsistent from issuer to issuer. For municipalities there are no quarterly reporting requirements, and annual reporting requirements are much more lenient than the corporate market.

### Municipal Market Participants

As of 30 June 2009, individuals, through the direct purchases of bonds and through mutual funds, made up the majority (approximately 70%) of the municipal investor universe. The largest issuers (year to date through 30 September 2009) are illustrated in Exhibit 1.

The larger states typically dominate the issuance in the municipal market. While the municipalities shown in Exhibit 1 have issued a large amount of debt, the number of issues is also high. In contrast, U.S. corporations generally issue much more debt in fewer issues. For example, Pfizer has 15 issues for \$30 billion of outstanding debt, and IBM has 26 bonds for \$19.2 billion of outstanding debt.

### Exhibit 1: Largest Municipal Issuers

|  | Amount (\$ billions) | Number of Issues |
|--|----------------------|------------------|
| California (State)                                     | 13.40                | 9                |
| New York State Dormitory Authority                     | 5.96                 | 36               |
| Puerto Rico Sales Tax Financing                        | 5.57                 | 4                |
| New York City Transitional Finance Authority           | 3.57                 | 7                |
| New York City  | 3.51                 | 8                |
| Illinois Authority                                     | 2.93                 | 29               |
| Wisconsin (State)                                      | 2.27                 | 8                |
| Washington (State)                                     | 2.24                 | 15               |
| University of California                               | 2.22                 | 5                |
| California Statewide Communities Development Authority | 2.11                 | 15               |

Year to date through 30 September 2009.

Source: Thomson Reuters.

## Structural Dislocation

Exhibit 2 illustrates how issuers met investors prior to the crisis. Intermediaries—including bond insurance companies, ratings agencies, and broker-dealers—were key in bringing buyers and sellers together. However, the crisis created major structural dislocations in the market, causing bond insurance companies' risk mitigation value to evaporate, investors to question rating agencies' methodologies, and stressing broker-dealers' balance sheets, which impaired liquidity. As a result of this dislocation in the intermediaries, issuers have struggled to find access to the capital markets and investors have struggled with access to liquidity. Government policy initiatives have helped to mitigate this dislocation, as evidenced by the rally of municipals in 2009; however, the structural dislocation still exists. We believe that these government initiatives are temporary and are not the long-term answer to address the dislocation in the municipal market.

### Exhibit 2: The Dislocation of the Municipal Underwriting Process



Source: Lazard

## Bond Insurers – The End of Commoditization

The role of the bond insurers was to provide the credit enhancement necessary for blanket AAA ratings, essentially commoditizing the municipal market from a credit perspective. As shown in Exhibit 3, only 9% of bonds were insured for the first nine months of 2009, while approximately 56% of

all new deals were insured in 2005. Downgrades have effectively ended the commoditization of the municipal market and issuers now must stand on their own. There are new entrants into the bond insurer industry; however, the amount of bonds that these new players have been underwriting has not been close to what it was in the past. For example, new entrant Berkshire Hathaway has underwritten only five issues for a total of \$583 million of debt for the year to date through June 30, 2009. In addition, only one of the original four major bond insurers—FSA, which was purchased by Assured Guarantee in July of 2009—has financial strength ratings that are high enough to continue to underwrite.

### Exhibit 3: Bond Insurers – Then versus Now

|                       | 2005        | 2009<br>(first 9 Months) |
|-----------------------|-------------|--------------------------|
| Ambac                 | Aaa/AAA/AAA | Ca2/CC/WD                |
| FGIC                  | Aaa/AAA/AAA | WD/CC/WD                 |
| FSA                   | Aaa/AAA/AAA | Aa3/AAA/AA-              |
| MBIA                  | Aaa/AAA/AAA | Baa1/A/WD                |
| % of Issuance Insured | 56%         | 9%                       |

Source: Bond Buyer.

## Rating Agencies – Loss of Confidence

Ratings agencies, which were validating the AAA status of the insurers, suffered an extreme loss of confidence during the crisis, as evidenced by the litigation against them over the past two years. What effect policies and ratings methodology changes will have is unclear at this point.

## Broker-Dealers – Continued Volatility

Previously, broker-dealers provided a consistent source of liquidity. Due to the dislocation, both the companies in this industry and their risk appetite have changed dramatically. The differences are clear when considering the top ten broker-dealers in 2007 versus the top ten broker-dealers for the first nine months of 2009, as illustrated in Exhibit 4. These changes have made it much more difficult to access liquidity.

## Exhibit 4: Broker-Dealers – Then versus Now

### 2007

| Rank  | Firm                | Amount Underwritten (\$M) | Issues |
|-------|---------------------|---------------------------|--------|
| 1     | Citi                | \$ 61,861                 | 603    |
| 2     | Merrill Lynch       | \$ 47,927                 | 423    |
| 3     | UBS                 | \$ 36,253                 | 613    |
| 4     | Goldman Sachs       | \$ 28,004                 | 182    |
| 5     | JPMorgan Securities | \$ 25,566                 | 338    |
| 6     | Morgan Stanley      | \$ 25,495                 | 255    |
| 7     | Lehman Brothers     | \$ 24,804                 | 250    |
| 8     | Bear Stearns        | \$ 24,630                 | 133    |
| 9     | Bank of America     | \$ 17,051                 | 402    |
| 10    | RBC Capital Markets | \$ 14,307                 | 568    |
| Total |                     | \$ 305,898                | 3,767  |

### 2009 (first 9 months)

| Rank  | Firm                          | Amount Underwritten (\$M) | Issues |
|-------|-------------------------------|---------------------------|--------|
| 1     | Citi                          | \$ 42,713                 | 298    |
| 2     | Bank of America Merrill Lynch | \$ 41,483                 | 373    |
| 3     | JPMorgan                      | \$ 33,655                 | 268    |
| 4     | Morgan Stanley                | \$ 27,260                 | 242    |
| 5     | Goldman, Sachs & Co.          | \$ 19,376                 | 132    |
| 6     | Barclays Capital              | \$ 18,253                 | 123    |
| 7     | RBC Capital Markets           | \$ 12,464                 | 433    |
| 8     | Wells Fargo & Co.             | \$ 8,529                  | 284    |
| 9     | Piper Jaffray & Co.           | \$ 8,202                  | 379    |
| 10    | Morgan Keegan & Co.           | \$ 8,099                  | 389    |
| Total |                               | \$ 220,032                | 2,921  |

■ Combined entities   
 ■ Exited the market   
 ■ New entrant

Source: Bond Buyer

## Challenges for Issuers

The dislocation of the three key intermediaries in the municipal market has led to a host of challenges for both issuers and investors. States, or the issuers, are experiencing very steep revenue declines in all three income sources for the first time in 15 years: personal income taxes, corporate income taxes, and sales taxes. This decline is illustrated in Exhibit 5.

In addition to the revenue declines, states are facing mandatory spending increases and a higher debt burden. Costs of Medicaid have increased, there are looming public pension payments, and the rise in unemployment has led to significant

increases in benefit payments. Simultaneously, debt per capita, debt to income, and debt service as percentage of expenditures went up significantly, limiting the municipalities' financial flexibility.

## Challenges for Investors

How can investors bridge the gap left by the dislocated intermediaries? First, it is important for investors to understand that there are many different issuers with different credit risks in the market. Second, investors should acquire independent credit review, which is necessary to assess the quality of the issue, as intermediaries are generally unreliable at this point.

## Exhibit 5: % Change in State Tax Collections vs. Same Quarter One Year Before

|           | 2007 Q1 | 2007 Q2 | 2007 Q3 | 2007 Q4 | 2008 Q1 | 2008 Q2 | 2008 Q3 | 2008 Q4 | 2009 Q1 | 2009 Q2 | 2009 Q3 (prelim) |
|-----------|---------|---------|---------|---------|---------|---------|---------|---------|---------|---------|------------------|
| PIT*      | 8.5     | 8.9     | 7.0     | 3.8     | 5.0     | 8.0     | 1.4     | -1.4    | -17.7   | -27.5   | -11.4            |
| CIT**     | 14.8    | 1.7     | -4.3    | -14.5   | -1.3    | -7.3    | -12.8   | -21.9   | -20.1   | 2.9     | -19.4            |
| Sales Tax | 3.1     | 3.5     | -0.7    | 4.0     | 0.6     | 0.3     | 4.6     | -5.3    | -8.3    | -9.5    | -8.2             |
| Total     | 5.2     | 5.4     | 3.0     | 3.6     | 2.6     | 5.0     | 2.7     | -4.0    | -11.7   | -16.6   | -10.7            |

Source: The Nelson A. Rockefeller Institute of Government

\*Personal Income Tax

\*\*Corporate Income Tax

Also, investors must be patient: Inventories are more dispersed, making it tougher to find bonds, and the over-the-counter market structure creates wide bid-offer spreads and liquidity challenges.

### Reality Check: Are the Risks Acceptable?

We often begin our analysis by reviewing the risks of a potential investment. The good news is that municipalities have a great history regarding bankruptcies and defaults. States and municipalities cannot file for bankruptcy; however, when required, they can restructure the terms of the debt, which is not necessarily a good outcome for investors. While bankruptcy or default may not be common, there have been many near-misses and investors should be aware of the fiscal stress on a municipality. In addition, municipalities are just beginning to feel the effects of the credit crisis and to deal with problems such as budget gaps and revenue decreases. Investors should be cognizant of how a municipality might manage these gaps given the amount of debt that the municipality itself carries.

### Opportunities

There is currently a high amount of credit differentiation in the municipal market, creating opportunities for those that

can recognize value, not just quality. For example, two states with the same credit rating may have very different fund balances, historical financial performances, debt per capita, or tax bases. There is also a high level of legal structure differentiation in the municipals market. Municipals come in different shapes and sizes, and paying attention to details in the terms and conditions and priority of the pledge can be critical. Due to the inconsistencies of reporting in the municipals space, considering the management team is also important. We believe that a municipality that posts disclosures frequently, in a timely fashion, and makes its management available to investors is key to the value of the issue. Last, we believe there is value in new issues, such as the Build America Bonds program.

### Conclusion

Despite the fact that structural changes have occurred and there appears to be no fast or simple resolution, the dislocation in the municipal market has created opportunities for those who actively engage risk. However, not all credits are equal, and we believe it is important for investors to focus on strong issuers and those securities that have acceptable risk characteristics.

#### IMPORTANT INFORMATION

Published on 07 January 2010.

This summary is being provided for informational purposes only. The information and opinions presented does not constitute investment advice and has been obtained or derived from sources believed by Lazard to be reliable. Lazard makes no representation as to their accuracy or completeness. All opinions expressed herein are as of the date of the conference call and are subject to change. This summary is not intended to, and does not constitute, an offer to enter into any contract or investment agreement in respect of any product offered by Lazard Asset Management and shall not be consider as an offer or solicitation with respect to any product, security or service in any jurisdiction or in any circumstances in which such offer or solicitation is unlawful or unauthorized or otherwise restricted or prohibited.

An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond's maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and prepayment risk, also apply. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one's home market. The values of these securities may be affected by changes in currency rates, application of a country's specific tax laws, changes in government administration, and economic and monetary policy.

Past performance is not a reliable indicator of future results.

The securities identified are not necessarily held by Lazard Asset Management for all client portfolios and should not be considered a recommendation or solicitation to purchase or sell any security. It should not be assumed that any investment in these securities was, or will be, profitable or equal to the investment performance of securities referenced herein.

© 2010 Lazard Asset Management LLC. **Australia:** Issued by Lazard Asset Management Pacific Co., Level 39 Gateway, 1 Macquarie Place, Sydney NSW 2000. **Germany:** Issued by Lazard Asset Management (Deutschland) GmbH, Alte Mainzer Gasse 37, 60311 Frankfurt am Main. **Japan:** Issued by Lazard Japan Asset Management K.K., ATT Annex 7th Floor, 2-11-7 Akasaka, Minato-ku, Tokyo 107-0052. **Korea:** Issued by Lazard Korea Asset Management Co. Ltd., 10F Seoul Finance Center, Taepyeongno-1ga, Jung-gu, Seoul, 100-768. **United Kingdom:** For Professional Investors Only. Issued by Lazard Asset Management Ltd., 50 Stratton Street, London W1J 8LL. Registered in England Number 525667. Authorised and regulated by the Financial Services Authority (FSA). **United States:** Issued by Lazard Asset Management LLC, 30 Rockefeller Plaza, New York, NY 10112.