

Lazard Insights

Conference Call Series

28 April 2011

Summary

Adjusting to the New Landscape of the Municipal Market

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Since the collapse of the monoline insurance companies during the financial crisis, the municipal securities market has undergone a structural adjustment as lenders and borrowers have had to re-evaluate previous assumptions about this marketplace. The municipal market has been quite volatile, as evidenced by the 23 consecutive weeks of net outflows.¹ We believe the present landscape of the municipal bond market—including current volatility, fund flows, and headline news—provides opportunities for investors to capitalize on the sound issuers in the market. The current challenge for investors is that the previously seamless process the intermediaries used to create a homogenous market has broken down. The risk reduction once provided by insurance companies has become unreliable. Rating agencies' methodologies have come under increased scrutiny and are being questioned. The constrained

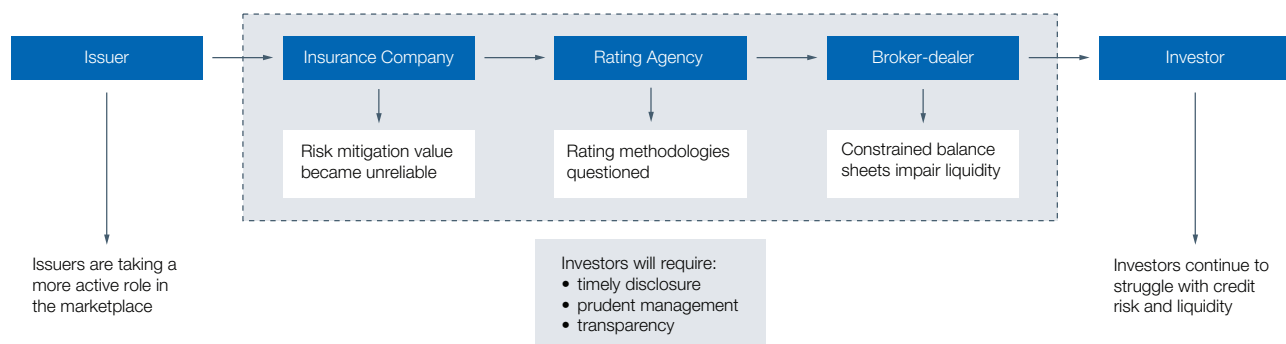
broker-dealer balance sheets have impaired the liquidity that was once supporting the market. Exhibit 1 illustrates this process of bringing issuers and investors in the municipal market together.

Municipal Market Dislocation

Municipal Issuers

Of the Triple A-rated municipal insurance companies that were in business as of January 2008, Assured Guarantee is the only municipal insurer that is truly active in the marketplace today. The role of bond insurers in the market has greatly diminished; they have not just been downgraded, but the previous business model failed. Prior to the recession, insured issuance approached 60% of the total market, whereas today only approximately 10% is being insured.²

Exhibit 1
The New Municipal Bond Market



For illustrative purposes only.

Ratings Agencies

The collapse of the rating methodology for the insurance companies led to a significant ratings downgrade throughout the municipal market. Exhibit 2 provides a comparison of the securities in the Bank of America (BoFA) Merrill Lynch Municipal Master Index by tracking the ratings for two static groups of securities: the first from January 2005 to December 2007, and then a

Exhibit 2 Rating Transitions in Municipal Securities

2005 to 2007*

Rating	2005 (%)	2007 (%)
AAA	60.69	62.64
AA	16.85	19.68
A	13.91	11.10
BBB	8.56	6.59
Total	100.00	100.00

2008 to 2011**

Rating	2008 (%)	2011 (%)
AAA	59.91	11.37
AA	20.13	49.43
A	12.30	26.58
BBB	4.66	12.62
Total	100.00	100.00

As of 31 March 2011

* 2005 to 2007 static credit transition analysis based on 7,368 out of 11,440 securities in the BoFA Merrill Lynch Municipal Master Index.

** 2008 to 2011 static credit transition analysis based on 7,518 out of 12,705 securities in the BoFA Merrill Lynch Municipal Master Index.

Source: Bank of America Merrill Lynch, Lazard

second group from January 2008 through March 2011. Specifically, the ratings from 2005 to 2007 show that, during the years leading up to the recession, the municipal market went through a series of upgrades across all ratings categories. However, the ratings from 2008 to 2011 demonstrate that the market then went through a complete downward shift. The stability and upgrades that the monoline insurance companies and the rating agencies provided to the marketplace were illusory.

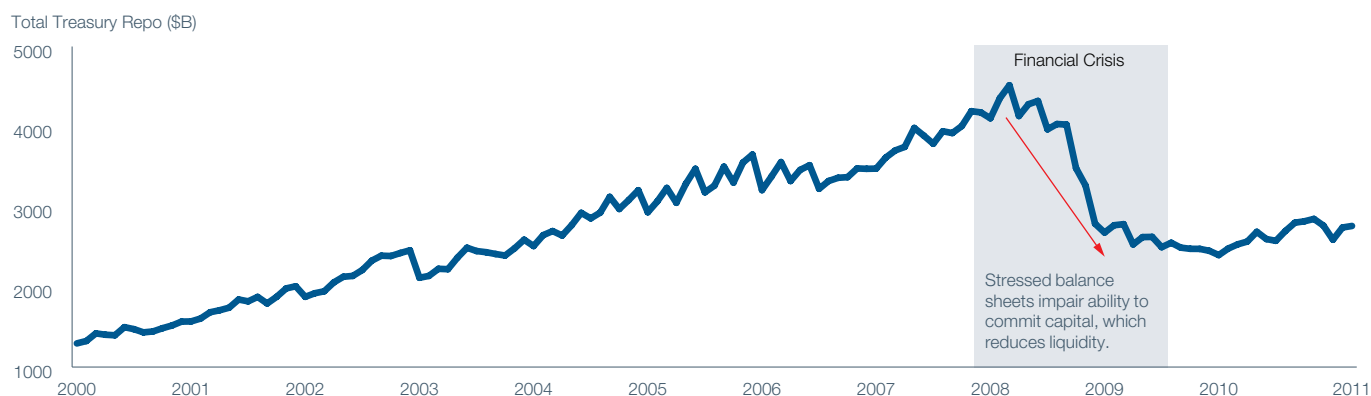
Broker-Dealers

Exhibit 3 illustrates the total Treasury repurchase agreements outstanding, which we use as a proxy for leverage in the marketplace. The highlighted section, during the financial crisis, shows that the leverage in the marketplace was reduced by half, essentially back to the same levels seen in 2004. This reduction in leverage highlights the contraction of broker-dealer balance sheets, which translates to less capital to commit to the sector, resulting in less liquidity. In addition, the non-traditional investors (i.e., levered buyers and proprietary trading desks, among others) that dominated the market in the years leading up to the recession are now marginalized due to the lack of available credit and higher volatility, which has also impaired liquidity.

State of the Municipal Market

Given these recent disruptions, we have seen individual investors begin to reassert themselves in the municipal market. Households have also been joined by some new entrants due to the success of the Build America Bonds (BABs) program, which was initiated in April 2009 and resulted in approximately \$200 billion of issuance. BABs are taxable, unlike the majority of municipal bond issues, and serve as an alternative to government and corporate bonds. This program was successful in tapping a new source of demand

Exhibit 3 Leverage Held by Institutional Investors



As of 31 March 2011

Source: Bianco Research, LLC

for municipalities. Critically, while many non-traditional investors exited the market during the recession, bringing this new buyer to the market was timely and successful in anchoring demand.

Due to the breadth, attractive risk compensation, and similarities in credit of the BABs program, investors who are active in the sovereign marketplace can now consider a new issuer, the municipality. Exhibit 4 provides an example of the risk compensation of municipalities versus other sovereigns around the world through a variety of metrics. A closer examination of the countries' total debt as a percentage of GDP; the debt service as a percentage of GDP; the budget gaps as a percentage of GDP; and, more importantly, the pension funding ratios, illustrates how different sovereign credits compare to each other. Investors used to analyzing sovereign risk can see that they are being paid considerably more to own a California bond than other sovereigns with less attractive credit metrics. On a sovereign risk comparison, municipals will often look attractive.

Further, U.S. fixed income investors who typically would ignore the municipal sector because of low nominal yields and liquidity concerns may now consider investing in the municipal sector. Exhibit 5 shows the spread between U.S. investment-grade corporates and taxable municipal securities. Currently, investors are being compensated more to own taxable municipal bonds than corporate bonds.

As municipalities are now often competing for capital globally with corporations, sovereigns, and other issuers, they have become more market-aware. Therefore, some municipalities are beginning to educate investors about the varying regulations and requirements that govern their space versus other issuers. In addition, regulatory bodies are creating more uniformity in reporting across the sectors. Rating agencies have completed the transition to a

Exhibit 4 Sovereign Debt Comparison Example

	California	France	Slovak Republic
Global Ranking Economy in the World	Top Ten	Top Ten	—
GDP per Capita (\$)	50,769	42,321	16,175
Unemployment Rate (%)	12.50	10.10	14.70
Total Debt (as a % of GDP)	4.6	80.9	27.0
Debt Service (as a % of GDP)	0.21	2.90	1.00
Budget Gap (as a % of GDP)	-10.00	-15.60	-20.00
GDP growth (%)	2.30	0.40	-4.70
Pension Funded Ratio (%)	87	pay as you go	pay as you go
5 Year CDS Spread*	210	80	81

As of 2009

* As of 27 April 2011; Source: Bloomberg

For illustrative and comparative purposes only.

Source: Lazard

uniform global rating scale across these sectors to make it easier for investors to compare issues as well. Municipal issuers that are adapting to this new environment and investors' demands will likely have greater access to capital.

Underlying Credit Conditions

Many states actually have been taking the steps to improve their balance sheets by making difficult fiscal decisions. In addition, investors may be surprised to learn that for five consecutive quarters states on average have shown revenue growth.³ Nevertheless, revenues are not yet back to pre-recession levels. Most states are reporting that they plan to return to those levels of revenue growth

Exhibit 5 Market Dislocation Has Created Opportunity

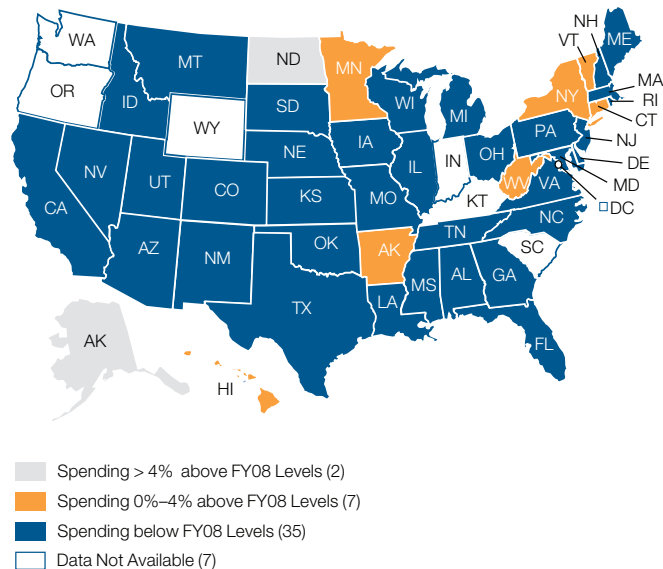


As of 31 March 2011

Source: Bianco Research, LLC

Exhibit 6

States' Spending Is Projected below Pre-recession Levels



As of 31 March 2011

Source: Bianco Research, LLC

between 2012 and 2014. Importantly, most states are implementing structural changes, including expenditure cuts. For example, as seen in Exhibit 6, 35 states have cut spending to below their 2008 levels.

This reduction in spending is unprecedented. However, states continue to struggle in this challenging environment, and there are many headwinds that still lie ahead. The Federal stimulus aid that was granted to states expires in the middle of this year, and property taxes collected on a local level are beginning to decline as they are now reflecting the drop in real estate valuations.

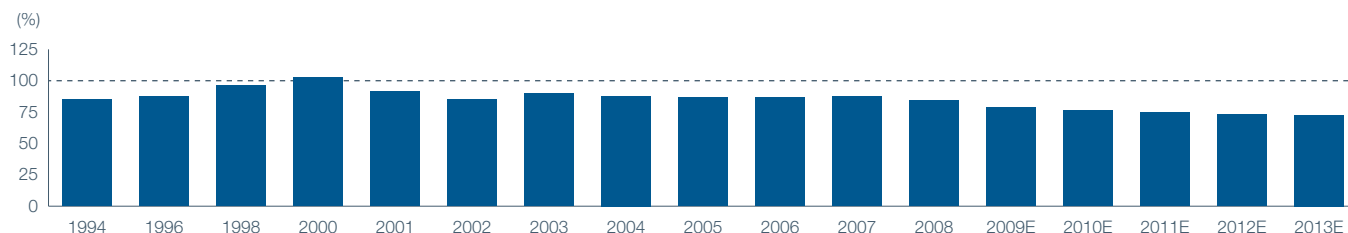
Other considerations that may affect underlying credit conditions are debt service and pension funding levels. On average, debt service levels are within the normal historical range. Most states and municipal local governments are spending 5% of general fund budgets on their debt service.⁴ Pension funding ratios are also within the normal range. Exhibit 7 shows aggregate state and local pension funding levels across the United States. In the past decade there has been only one year, 2000, where pensions, on average, were fully funded. It would be naïve to assume that pensions would be fully funded every year. Municipalities are quasi-not-for-profit entities, and during a recession we would expect revenues and funding ratios to drop. We view these obligations as manageable, but nonetheless we recognize that future pension obligations will remain a longer-term structural challenge.

Despite the current underlying strength of the market, there are some key factors to monitor moving forward. Recently, headlines surrounding bankruptcies have caused investors to focus on their likelihood. It is important to note that, currently, no federal law exists to allow a state to file bankruptcy. There are Chapter 9 provisions for local governments, but only in 26 states. In some of the states that do allow a municipality to file Chapter 9, the municipality must obtain authorization to do so. In fact, there have been only 600 bankruptcies since the 1930s, which is low given the size of the market.⁵ However, history may not be a good guide if attitudes toward bankruptcy change. We have been concerned that the threat of bankruptcy could be used as leverage or a bargaining chip in an effort to renegotiate contracts.

Health care spending is another significant headwind. These costs are already a major component of states' budgets.⁶ The impact of the Affordable Care Act that was passed in 2010 is unknown at this time, but it is probably safe to assume that costs will be higher in the future. The law is being challenged in the courts by a number of parties; nevertheless, states still have an obligation to account for the new regulations.

Exhibit 7

Current Municipal Debt Service and Pension Funding Levels Are Manageable



As of 1 April 2011; Source: Center on Budget and Policy Priorities, "Misunderstandings Regarding State Pensions and the State Fiscal Crisis"; data not available for 1995, 1997, 1999.

Estimated data is not a promise or guarantee of future results and is subject to change.

From a regulatory perspective with the passing of Dodd-Frank and Basel III, we believe there will not be a fundamental restructuring of the municipal market. However, as leverage that was in the marketplace is not likely to return any time soon, the unintended consequences of these regulatory changes remain unknown.

Navigating Uncertainty

There is a wide range of issues that investors should consider in the current municipal landscape. The dislocations in the market as insurers, rating agencies, and broker-dealer models go through this period of adjustment provide investors an opportunity to focus on the sound borrowers that continue to come to the market for capital. Some of the fundamental features of borrowers that we focus on include:

- independence—can raise taxes or rates without approval,
- essentiality—have a natural monopoly or large market share, and
- self-sufficiency—generate enough revenues.

We also examine management practices and look for:

- transparency and governance,
- timely disclosure,
- successful management track record, and
- proactive responses to fiscal and market challenges.

Finally, we believe investors must remember to focus on the terms and conditions of the bonds. Investors should differentiate among the elements of the bondholder protection. Not all general obligations are the same and not all revenue bonds are the same. Some questions to consider include:

- Is the general obligation pledge constitutional?
- Is it a priority pledge?
- Is it a legal obligation or an appropriation promise?
- Do debt limits exist?
- Are there any constraints on raising taxes or revenues?

Finally, outside of the credit analysis, we focus on the securities' structure to understand these additional drivers of expected return. What does the bond structure look like: coupon, maturity, optionality, if any, etc? The terms of the loan and how they are priced matter.

The volatility and uncertainty that we have seen in the municipal marketplace can provide favorable entry points for those investors that focus on issuers that are financially sound. It is critical to pay attention to these details as they will differentiate the winners from the losers in the end.

Notes

- 1 Bank of America Merrill Lynch, 2 May 2011.
- 2 The Bond Buyer, 31 December 2010.
- 3 Rockefeller Institute, "State Revenue Report," April 2011.
- 4 Center on Budget and Policy Priorities, "Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm," 20 January 2011.
- 5 Latham & Watkins, 12 April 2011.
- 6 Scott Leitz, "Health Care Cost Growth, Driver, and Implications for States," www.familyimpactseminars.org, 5 July 2007.

Important Information

Published on 17 May 2011.

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