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MARKET OUTLOOK



By Mike Davis, CFA, CIC

After suffering through a terrible year in 2008, the stock market continued to decline in January and February of this year, but has staged an impressive rally in March. As we expected, the financial crisis of late last year has spread to the rest of the economy with consumer and business spending declining, exports falling, and unemployment rising. Although we anticipated a recession (and thought the stock market

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THE MUNICIPAL BOND EARTHQUAKE: Security in an Insecure World



By Ed Ogle, CSA and Randy Zaharia, CFA

The year 2008 will go down as a year that sent a number of credit quakes and shivers throughout the financial markets. From the fall of Bear Stearns to the collapse of Lehman Brothers and the implosion of American International Group, the meltdown of the mortgage bond markets, especially those with sub-prime mortgages, reverberated everywhere. However, the greatest disruption may have occurred in the municipal market with the fall of the municipal bond insurers.

Many bond insurers were heavily involved in insuring securitized mortgage bonds. When this mortgage market imploded, insurers wrote off large amounts of mortgage bond debt. Many insurers were substantially downgraded from their AAA ratings, including some who ultimately fell to non-investment grade status. With the AAA-rated insurers basically wiped out, most municipal bonds began to trade strictly on the underlying credit and fundamentals of the issuer, rather than the insurer. The bottom-line result was that the entire municipal bond market froze up for periods of time during 2008, and fewer new bonds were issued.

Finally, the national economy, which was sluggish through much of 2008, took a dramatic downturn in September 2008. Fourth quarter GDP dropped by over 6% (annualized) and tax revenues faltered everywhere, but nowhere more dramatically than in California, the biggest state and municipal market in the United States.

Risk Concerns with the State of California

In December 2008, Standard & Poor's lowered its underlying rating on California's \$46 billion of general obligation (GO) debt from A+ to A, and labeled the outlook for California as stable. Moody's, also assigning a stable outlook to the State, lowered its rating on California GOs to A2. These ratings actions reflected ongoing concerns about the State's costs and ability to enter the capital markets, prior to reaching an agreement on a mid-year budget revision last February.

California's present credit ratings, though down-graded, still underscore the State's strong long-term economic fundamentals, including broad economic diversity, depth of resources, and mechanisms for the collection of tax revenues, despite short-term cash flow concerns. The State has structural economic advantages such as the ongoing ability to attract venture capital for high-technology and emerging industries as well as a generally well-educated workforce. Additionally, California's gross state product is large

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MESSAGE FROM THE PRESIDENT



By Peter Boyle,
CFA, CIC

There is something nice about Spring.

For baseball fans it means the beginning of the baseball season. If you are a basketball fan, March Madness provided 33 hard-fought college basketball games. And for those like me who are fans of the outdoors, while snow is still plentiful in much of the country, the warming weather brings fields of wildflowers into bloom—a pleasant distraction from the tumultuous financial markets.

With these seasonal changes, we take note of some new regulatory issues which may affect our clients. Last September, California joined many other states in adopting the Uniform Prudent Management of Institutional Funds Act (UPMIFA) which governs the management and use of endowed institutional funds held by charitable institutions. UPMIFA is based on two general principles: 1) Assets should be invested prudently in diversified investments to seek growth as well as income;

2) Appreciation of assets can prudently be spent for the purposes of any endowment fund held by a charitable institution. While this may seem fairly straight-forward, this does mean there are a couple of important changes for California charitable institutions. Please ask us if you want more specifics.

Moving on to Washington, while not yet enacted into tax law, there is strong evidence within President Obama's budget blueprint that estate taxes and exemption levels will remain at 2009 levels into 2010. This is significant since estate taxes were scheduled to be eliminated during 2010 before reverting to 2001 levels in 2011.

In other news, I was recently asked by the Pasadena Star News to comment on the Madoff scandal and his sentencing. For those of you who may not have had a chance to read the article, let me reiterate a couple of my points. First, I am glad Madoff was sentenced as severely as he was. Our industry relies on a high level of fiduciary responsibility. However, despite this sentencing, Madoff will not be the last advisor who attempts to dupe investors, and no amount of regulatory

oversight will stop it all. To this end, I made some further comments on lessons learned which are worth repeating: 1) Separating your advisors from your custodians is critical when making these non-transparent, partnership investments. Doing so creates an additional level of checks and balances. 2) While investing is complex, a basic understanding of your investments is important. Madoff's investments appeared to have had surprisingly consistent positive results even during the final months. A bit of skepticism might have provided some warning signs.

On a final note, as our Market Outlook article points out, Spring in the financial markets may also have begun to melt what has felt like an eternal winter freeze. Acknowledging we still have a ways to go, these warmer days of spring have provided improved economic data which CNBC dubbed "mustard seeds" of hope and optimism. It is hard to get overly optimistic given the drumbeat of negatives, but it is important to remember that six months ago there were not even mustard seeds. So, while the cycles of financial markets don't possess the calming reliability and predictability of the seasons, it is helpful to remember that positive periods do follow the tough times. ♦

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and represents approximately 13% of the national gross domestic product.

Despite the State's strong longer-term economic fundamentals, however, the prospects for an imminent or brisk economic and revenue recovery appears to be unlikely. Unlike the Federal government, the State Constitution requires a balanced budget, a practice endorsed by voters with Proposition 58 in 2004. With respect to the near-term budget gap, the Governor's budget for fiscal 2010 establishes a framework to close the budget gap with a combination of spending cuts, revenue increases, and short-term borrowings

(almost \$10 billion). Among the specific cash-saving actions, either already in place or set to be implemented by the State, are freezing funds in the State's pooled money investment account and furloughing nearly 238,000 state employees for two days a month for roughly the next year and a half. Based on pro forma cash flows and representations by state officials, it is expected that the State will continue to meet its required education and debt service payments (priorities #1 and #2, by State Constitution).

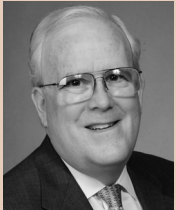
Unfortunately, these actions required by the State to preserve cash to meet its higher-priority obligations are coinciding with a marked softness throughout the

labor market. According to the State's Employment Development Department, the State incurred non-farm job losses during the first quarter of 2009 that raised the State unemployment rate to over 10%. All of which raises the question, is California in danger of declaring bankruptcy?

According to Federal law, California does not have the option of Chapter IX bankruptcy, as only "taxing agencies and instrumentalities of the State" are eligible. In other words, while it is apparent that the State does not have the right to file in Federal Bankruptcy Court, individual municipalities and agencies can

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ISSUING NEW GIFT ANNUITIES IN AN Old Bear Market

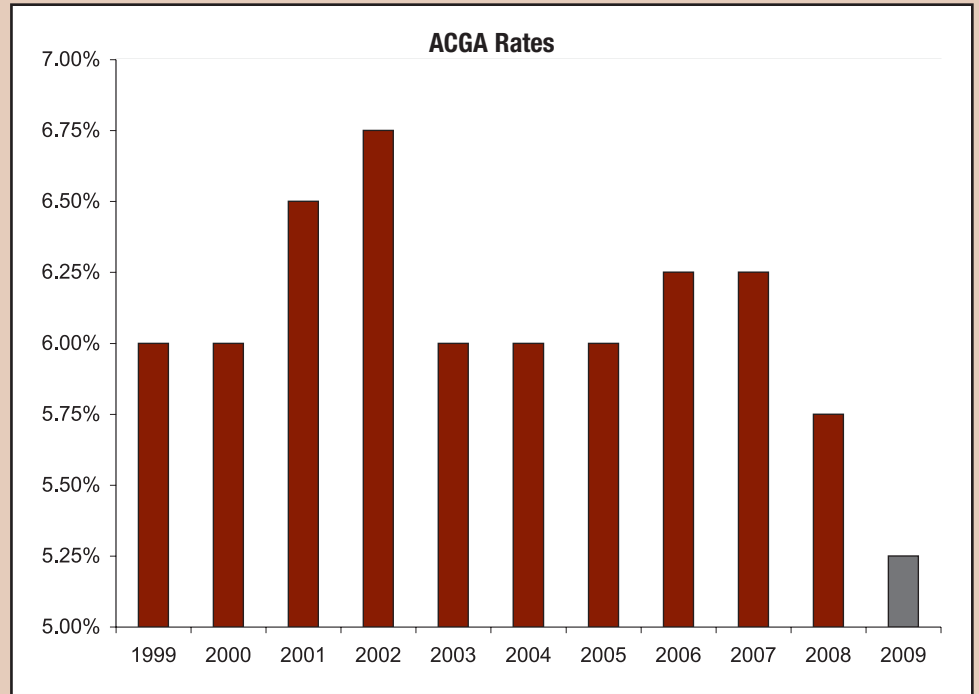


By Terry Price

With stocks down 50 percent in the past year and a half, many gift planners are wondering if issuing new gift annuities is a prudent decision for now and in the future. Or are the risks to the issuing organization simply too great? By their nature, these planned giving arrangements provide an immediate and guaranteed return to the income beneficiary. However, an eventual payoff to the charity is much more unpredictable and may take years to be realized. In addition, during that time the charity assumes all of the risks, not the least of which involves investments.

Effective February 1st, the American Council on Gift Annuities (ACGA) recommended lower gift annuity rates to donors. These lower contract rates are based on the lowest, most conservative investment assumptions we've seen in over a decade. Simply acknowledging the lower, more conservative annuity rates is not sufficient to assuage concerns over the risks assumed by charities in offering gift annuity programs. As investors, we prefer to review the investment assumptions behind the rates. By understanding these assumptions, gift planners should be in a better position to make judicious decisions on the issuance of gift annuities in the currently disquieted investment environment.

As most readers know, the ACGA assumptions have traditionally been quite conservative. The newly lowered annuity rates continue to reflect the his-



torical conservative precedent of the past. Here are the basic assumptions driving the recent annuity rate changes:

- The residuum realized by the charity upon termination of an annuity is assumed to be 50 percent of the initial gift value. No change here.
- Life expectancies are based on the Annuity 2000 Mortality Tables for female lives with a two-year setback in ages. This assumption has become more conservative during the past few years. Until recently, the assumption was only a 1.5 year setback in ages.
- The new rates also incorporate projections for increasing life expectancies over time.
- Annual expenses for investment and administration are one percent of the fair market value of gift annuity reserves.

Constrained by the above assumptions, and reflective of the current investment environment, the total annual investment return assumed on gift annuity reserves has now been reduced to just 5.25 percent before annual expenses. This is a decrease from 5.75 percent last year. As shown on the chart above, it is the second significant reduction to investment expectations in just the past two years.

To better understand the risks a charity might take investing newly established gifts, let's look at the specific investment presumptions needed to produce the 5.25 percent anticipated target return. As it has been for years, the ACGA assumed long-term portfolio asset allocation is as follows:

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PAYING FOR COLLEGE: A Reality Check



By David Andrew

This is that special time of the year when many high school seniors are the first to check the mail each afternoon. They are looking for that wonderful acceptance letter from their favorite college (many colleges are now sending their acceptance notices through e-mail). Students and parents are elated when the envelope brings good news. But then, in quieter moments, the parents oftentimes ask each other whether they are financially prepared to make their child's dream become a reality. This scene is being repeated in families all across the country, especially after the severe bear market of the past year. Sometimes the joy of the occasion can be subdued by a harsh reality check.

For more than a decade the cost of a college education has risen more than twice as fast as the Consumer Price Index. Surveys reveal that most parents still think that grants and scholarships will pay for a large part of their children's college education costs. Unfortunately, these parents are living in a dream world. Grants and scholarships are primarily based on financial need with only 10 percent based on merit alone. Typically, a family with a pretax income of \$70,000 or more will end up paying for most college education costs through personal savings, current earnings and/or loans. However, this should not discourage a family from trying to obtain financial aid. If there are two children in college, the odds of getting some aid are far better.

Many articles deal with the subject of saving for college (see Newsletter article on 529 Plans in Fourth Quarter 2005 issue). The 529 Plans are one of the newer saving vehicles but performance has been affected by the lack of investment choices, higher expenses and the recent market

downturn. This article will deal with some basic ways to actually pay for college once the student is about to graduate from high school. The subject of college financial aid is an extremely broad area so this article does not attempt to address every source of aid or any unique situations but will concentrate on non-need-based options.

That being said, the main sources of college financing include loans, grants, scholarships and personal savings. The process of applying for assistance starts with completing the Free Application for Federal Student Aid or FAFSA (www.fafsa.ed.gov). While most college specialists recommend completing the FAFSA, one needs to be realistic about the outcome as even among those applicants who are awarded aid, the amount awarded will not cover the majority of expenses. Some schools actually hold workshops on how to properly complete the FAFSA form in order to increase the chances of successfully qualifying. One should plan to submit the FAFSA form in January and then update the form once taxes are completed. Usually, the FAFSA needs to be updated each year for most types of financial assistance.

The types of college loans available are mainly federal and private. Federal loans are both need-based and non-need-based (see www.studentaid.ed.gov). The main non-need-based Federal loan is the Unsubsidized Stafford Loan which allows one to borrow up to \$27,000 (Freshmen = \$5,500, Sophomore = \$6,500 and Junior and Senior = \$7,500). The interest rate is fixed at 6.0 percent and the repayment period is 10 years. Another non-need-based Federal loan program is called Parent Plus. Plus loans are low interest rate federally insured loans for parents of undergraduate students. Parents do not have to demonstrate financial need to borrow on a Plus loan, but must have a good credit rating. Plus loans can be used to pay any educational

expenses not covered by other forms of financial aid. The variable interest rate is currently 5.01 percent and the repayment term is up to 10 years.

Private loans are also available from banks and other finance companies. It is usually best to first check what the college has to offer. Private student loans, which typically carry variable rates that are based on the borrower's credit history, should generally be the loans of last resort for families. Parents and students should do their homework before making decisions that could cost thousands of dollars over time.

College grants come in two main categories: Federal and State Grants. Federal Grants include three types: Federal Pell Grants, Federal Supplemental Educational Opportunity Grants (FSEOG) and Academic Competitiveness Grants. College grants from the State of California include the Cal Grant A, Cal Grant B and Cal Grant C. All these grants are need-based and mentioned here for informational reasons, but not as pertinent to our exploration of non-need based options.

The main difference between scholarships and loans and grants is that scholarships are primarily based on merit. Academic scholarships are usually based on the student's grade point average and test scores (see www.collegeboard.com and www.act.org). Many colleges offer various types of academic scholarships; however, they may still require the FAFSA application.

Athletic scholarships are usually for one year at a time and can pay for all or some of the total college costs. The National Collegiate Athletic Association (NCAA) is the athletic governing body for most colleges and universities (see www.ncaa.org). Verification of academic preparation in high school is required for Division I and Division II college athletes. The NCAA Initial-Eligibility Clearinghouse handles all inquiries regarding an individual's initial NCAA eligibility status. When considering the possibility of an athletic scholarship, a family needs to be realistic and know that the scholarship offer(s) may come from a college

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	Allocation
Stocks	40%
Bonds (10-Year)	55%
Cash	5%

With this asset mix favoring the highest-quality bonds and cash, one can infer the investment results needed to produce a 5.25 percent total portfolio return. Specifically, the big risk in today's investment environment is what should be expected of stocks in the future. One way to analyze the situation is to use current available rates for both cash and 10-

As investors, we prefer to review the investment assumptions behind the rates.

year Treasuries and then solve for the return required of stocks.

In today's marketplace, we find cash investments easily returning 1.0 percent while 10-year Treasuries can be purchased to yield just 2.7 percent to maturity. Given those realities, stocks would have to provide an average annual return of 9.3 percent as shown in the following table.

	Allocation	Return
Stocks	40%	9.3%
Bonds (10-Year)	55%	2.7%
Cash	5%	1.0%
Total Return		5.25%

However, with some minor adjustments to the return assumptions for both cash and bonds, the required gain from equities drops dramatically. If the yield

on bonds increases from 2.7 to just 3.5 percent, and cash returns rise from 1 to 1.5 percent, the requirement of stocks drops dramatically to 8.1 percent.

	Allocation	Return
Stocks	40%	8.1%
Bonds (10-Year)	55%	3.5%
Cash	5%	1.5%
Total Return		5.25%

Another approach in testing sensitivity is to retain the returns currently available from Treasuries and cash, while changing the asset allocation mix. Specifically, increase stocks by 10 percent while simultaneously reducing bonds by 10 percent. As above, the required stock return drops significantly as shown below.

	Allocation	Return
Stocks	50%	8.0%
Bonds (10-Year)	45%	2.7%
Cash	5%	1.0%
Total Return		5.25%

As investors, what conclusions might we draw from these analyses? Are there other considerations? And if so, what are they?

We believe there are other factors which come to bear. First we consider the general level of valuation we find in all three asset classes at the present time. As for Treasury bonds, during the past 18 months Treasuries have become safe havens for skittish investors exhausted by volatility and the downward march of equities. Huge amounts of cash have found refuge in their relative safety from the storm. Unfortunately, the price for safety is

now a below-average interest rate. Although difficult to predict with great certainty, we feel over the coming years interest rates on Treasury bonds are likely to be higher rather than continue significantly downward from current levels.

Second, are there alternatives to Treasury bonds which at the present time offer more profitable results? Is it possible to find higher yields in other fixed-income instruments without greatly increasing credit risk? We believe the answer is yes. In the area of gift annuities, we acknowledge state regulations often influence the types of investments allowed in investment pools. That said, in today's market, we find good value in high-quality agency, corporate and municipal bonds. Given these facts, is it likely one could expect a 4.0 percent return from an unrestricted, yet high-quality bond portfolio both today and in the future? In a word, yes.

Third, how about cash investments? Is the one percent assumption too low? Again, we believe it is. Money market funds presently yield one percent or less – the cost of safety and maximum liquidity. Alternatives exist in various high-quality cash options such as bank CDs. Returns in the area of 1.5 to 2.0 percent are certainly available to investors today.

Putting it all together, what would happen if we were to increase the equity weighting by just 5 percent? And instead of just Treasuries we invested in today's real-market Treasury alternatives as well as higher-yielding CDs? The future return demanded from stocks drops to just 7 percent. Is that return low enough to satisfy the investment risk to charities desirous of maintaining a gift annuity program? To that question, there is not one universal answer. Each institution must decide for itself, based on all factors unique to it – many of which lie outside the world of investments. But through this discussion, we hope to provide some insight as to reasonable investment considerations when gift opportunities present themselves in the near future. ♦

decline had largely discounted or factored in our worst case scenario), we underestimated how steep the economic slide would be and how long it might last. We also thought the stock market might get an “Obama Bounce” from the government stimulus program, but thus far the market

What can we do to protect capital while preserving the ability to participate in growth when it finally comes?

seems to be saying that even the massive scale of the spending and tax package will not be sufficient nor timely enough to prop up the economy in the near term.

An additional element which may be unnerving the stock market is the possibility that government actions to date are fighting the symptoms of the problem (declining spending, unemployment, etc.) and not the root problem (the rapid deflation of a debt-financed asset bubble in real estate and other investments) which is relentless and still hasn't run its course. This line of thinking postulates that the economy needs to make a massive downshift in size as consumers and businesses stop the debt-fueled buying spree they have been on for the past few years. In turn, excess assets in the form of houses, buildings, production facilities, and shopping centers have to be sold in order to pay off the debt which financed them. Consequently, many of the people who were employed in these enterprises will be laid off.

This deleveraging process will continue until the asset sales are completed, prices stabilize, and a new equilibrium level of economic activity is reached. In the meantime, even people who have jobs will likely cut back on their spending to pay down debt or because they feel poorer due to the decrease in value of their homes and their stock portfolios.

Individuals and businesses will not

want to borrow and banks will not want to lend until this downsizing is finished and the balance sheets of the respective participants are de-leveraged. There is little the government can do to stop or slow this process down, and in the long run it would only delay the inevitable to do so.

Can we survive this turmoil, and what will the world look like if we do?

The answer to the first question is yes, and the government can help here by ensuring there is sufficient liquidity in the financial system

and enough capital in place to facilitate the deleveraging of balance sheets. As to what sort of economy we will have, no one knows because we have never been in this situation before. However, here are some likely outcomes:

1. The economy will be smaller but on a more solid footing because the excesses of the past will be washed away.
2. The balance between the public and private sectors will shift dramatically toward the public side.
3. Corporate profits will be lower than they are today.
4. Growth will be slower than in the past because:
 - There will be more government intervention in the capitalist system.
 - Private debt will be used more sparingly.
 - Government debt will grow and private debt will shrink. The burden of servicing this debt will be a drag on the economy.
 - Social programs and higher taxes will drain funds from the private sector.

How much longer will this last? We are already almost a year and a half into the deleveraging process and the correc-

tion in stock prices may be close to an end. Residential housing prices have also declined substantially, but probably have further to go before reaching historic norms. Commercial real estate and credit card debt will likely be the last areas to stabilize. The financial system is still functioning—not perfectly, but the panic of last Fall has not reappeared. More pain may lie ahead, but we are certainly much closer to a new equilibrium level than was the case this time last year.

What can we do to protect capital while preserving the ability to participate in growth when it finally comes?

1. Maintain a conservative allocation between stocks, bonds and cash which entails:
 - Maintaining above-average amounts in cash and bonds.
 - Trimming or eliminating stocks which are most vulnerable to financial and economic stress so as to redeploy funds into stocks of companies with stronger balance sheets and better recovery prospects.
2. Hold only the highest-quality bonds and stocks.
3. Limit bond maturities so as to protect principal against the possibility of inflation in the future.
4. Diversify.
5. Look for stocks with secure dividends which provide an above-average dividend yield and the prospects of some dividend growth in the future. This is important because in the slower growth economy we foresee, a greater portion of the return from stocks will likely come from dividends.

These have been extraordinarily trying times for all of us. Though tested in unprecedented ways, we believe our fundamental principles and investment disciplines continue to hold true. With patience, we look forward to the recovery of our economy and financial markets. ♦

which is not at the top of their list.

The Reserve Officer Training Corps (ROTC) offers competitive scholarships which may include up to complete tuition, fees, books and a subsistence allowance at most universities. See (www.rotc.com, www.afrotc.com and www.navy.com). The scholarship value may exceed \$80,000 at some private universities. Not every college has a ROTC detachment on campus for each service branch. These scholarships are based on the military's needs and require a minimum 4-year active duty commitment following graduation.

The last and most important source of college funds are private savings plans and part-time student jobs. The private savings plans include 529 Plans, Education Savings Accounts and student college savings accounts. Since many of these savings plans are invested in the stock market,

they have seen their values diminish over the past year. This situation has caused many families to wonder if they still have adequate funds to support the costs of college. Although no one can predict the future direction of stock prices, we believe it is prudent to follow a strategy based on previous experience and recent research.

Parents of college students are searching for a recovery plan that will preserve the account value and ensure that their savings can fulfill their needs. While the instinct may be to flee the risk of the equity markets and switch to bonds, this strategy is usually counterproductive. One recent study showed that when the stock market (represented by the S&P 500 Index) is priced as cheaply as it was near the end of 2008, the average annual return over the following five year period has historically been between 10-15 percent.

Another strategy is to consider temporarily reducing the withdrawals from one's nest egg. Large amounts of money that are taken out of portfolios will not be invested to earn returns in succeeding years when the market recovers. The third strategy is to find the right balance between an investment allocation and an appropriate withdrawal strategy. Generally, most parents in these situations would be much better served by sticking with some allocation to equities. Parents should still keep in mind that, while assumptions about average market returns and volatility can be made with some confidence over long periods, there is much less certainty over short periods. No one knows the depth or duration of any bear market—or the strength of any recovery. However, following these recommendations should help parents to stretch their available college funds farther in an effort to keep up with rising education costs. ♦

QUESTION & ANSWER



By Jim Gamb, CFA

Despite the market's decline, 2009 might seem like any other year for retirement accounts, but that is really not so. It's important to keep track of your IRA in view of significant changes which have taken place.

What is the most significant change?

By far, the biggest change came as part of the Worker, Retiree, and Employer Recovery Act of 2008. Under that law, required minimum distributions (RMD) for IRA owners and 401(k) and 403(b) plan participants and beneficiaries are waived for 2009. *Please note that you are still required to take your RMD if you turned 70½ in 2008 but decided to wait until this year to take your initial distribution.*

Can IRA owners still contribute IRA funds to a charity?

Under the Emergency Economic Stabilization Act of 2008, sometimes called the "bailout bill", IRA owners who are 70½ can transfer up to \$100,000 to a charity in 2009 without

having the amount included in their gross income. The act extended for 2008 and 2009 the original provision which expired December 31, 2007.

Are there important conditions which qualify a charitable contribution?

Yes, there are two important rules. First, the gift must go directly from the IRA to the charity. Second, the gift must be made to a tax-qualified non-profit group. Some charities aren't eligible, including charitable trusts, donor-advised funds and private foundations.

In view of the market's significant decline, would it be more advantageous now to convert to a Roth IRA?

Moving assets from a traditional individual retirement account to a Roth IRA is a way

to take advantage of the market's decline because less tax will result from conversion at today's lower value. To be eligible to convert to a Roth, your modified adjusted gross income must be no more than \$100,000 a year, either for an individual or a married couple filing jointly.

Next year, the opportunity is even greater. Starting in 2010, there are no income limits for Roth conversions. In addition, you can spread any resulting income taxes across 2011 and 2012 for conversions done next year. Since tax rates may increase in the next few years, paying the tax now could be advantageous and you (or your heirs) will never have to pay taxes on the amounts withdrawn.

As always, these are complicated issues and no change should be made without consulting your tax advisor. ♦

PROFESSIONALS

Maye Albanez, CFA, CIC
S. David Andrew
Carolyn S. Barber, CFA, CIPM
Peter J. Boyle, CFA, CIC
James R. Brown
Michael G. Davis, CFA, CIC
Kenneth H. Dike, Esq., CPA
James D. Gamb, CFA
Roger L. Gewecke, Jr., CFA
Kathleen Gilmore, CFP®
Kathleen M. Habegger, CFP®
Edward P. Ogle, Jr., CSA
Maxwell R. Pray, CFA
Terrell H. Price
Ralph E. Weil, CFA
Bruce C. White
Randall L. Zaharia, CFA

OFFICES

Pasadena

200 South Los Robles, Suite 320
Pasadena, CA 91101
626.792.2228 Phone
626.792.2670 Fax

Huntington Beach

16902 Bolsa Chica Street, Suite 204
Huntington Beach, CA 92649
714.846.2851 Phone
714.840.5212 Fax

Evergreen

P.O. Box 2945
Evergreen, CO 80473
720.746.1244 Phone
720.294.9896 Fax
www.cliffordswan.com

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declare bankruptcy, and have. In addition, given the 10th amendment of the U.S. Constitution, there is substantial deference to State's rights over the federal bankruptcy laws. Thus, the Feds will defer to the State with respect to municipalities filing for bankruptcy within California. Where then, as investors, can we find the stability we expect from owning municipal bonds?

The key elements of strong municipalities and agencies include good, reliable revenue flows and good geographic areas, as well as necessary services. As noted above, education is the top priority in the State budget, and past actions by the County and State Departments of Education show that there is strong support for most school districts in the State. Also, essential service bonds rely on the strength of water or sanitation revenues, for example, which should remain predictable and possibly even increase.

In general, most municipalities appear able to weather the severe economic storms now raging. The track record on bankruptcies in the municipal sector is excellent relative to the corporate sector, although the severe recession will cause a few more bankruptcies to surface. The Orange County and City of Vallejo filings are reminders that these do happen and that rigorous credit research can help avoid exposure to these issues.

Municipal Bond Management Strategies

Given all the difficulties in the municipal bond markets, Clifford Swan's in-depth credit review process is critical in the identification of solid municipal bonds and attractive values. As part of our thorough review of the bonds considered for purchase, the issues' Official Statements and financials are properly evaluated, along with the financial characteristics (security of cashflows, etc.) of the underlying projects. We must consider the local economic and geographic reality of the issuer. Approved taxpayer-voted bond elections are given special preference, along with essential service bonds such as

water, sewer, and power bonds.

Finally, all bonds currently held and future additions to portfolios are closely scrutinized for any changes indicated by the credit watch processes of the different ratings agencies. We do not always accept the ratings provided by the three primary rating services, and we no longer accept municipal insurance as providing meaningful credit support to issues that we own in our clients' portfolios. We consider insurance as the last part of the review process, but it is only one of many factors that we currently evaluate.

Current Municipal Market Expectations

Much has happened in 2008 to reshape the municipal bond landscape. The critical factors for 2009 and beyond are the continuing impact of the recession, the decline in municipal finances, and the impact of federal stimulus efforts. Specifically, we anticipate:

- Massive increases in Federal deficits/debt and new tax initiatives will dominate bond market dynamics throughout 2009 and beyond.
- Deteriorating credit fundamentals will be ongoing as state and local governments struggle to meet their obligations in a low-growth environment. High levels of new issue supply will remain a negative for municipalities as they finance their budget gaps over the near-term, raising longer maturity yields.
- Yield curves for municipal bonds and U.S. Treasuries should increase over the next several years, especially in longer maturities.
- Essential purpose municipal bonds, e.g., water, sanitation, power/transmission lines, and airports, will continue to be important issues of choice.

So, while there are a lot of severe economic winds blowing and many uncertainties ahead, we believe that the State of California and most of its issuing municipalities and agencies will remain creditworthy. We continue our vigilance over our current holdings and remain watchful for new opportunities. ♦