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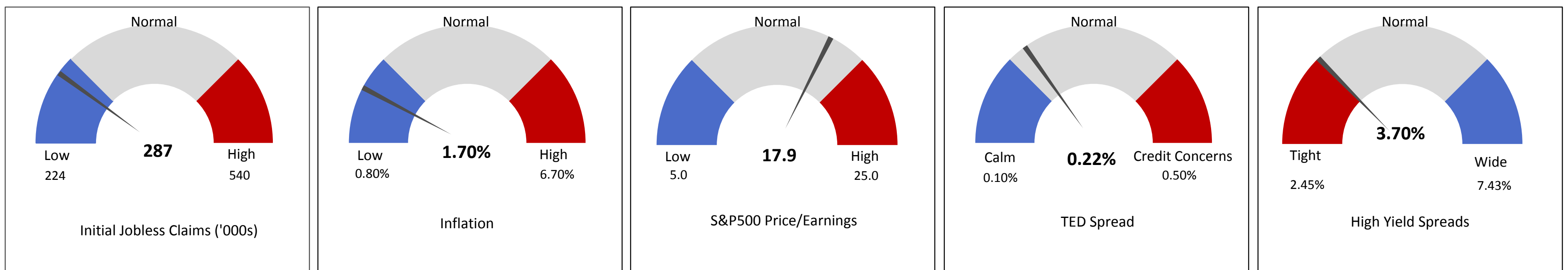
Market Digest

Third Quarter 2014



Municipal Market Update

Source: San Diego Union-Tribune , March 16, 2011. By permission of Steve Breen and Creators Syndicate, Inc.

The global financial crisis of 2007/2008 and its aftermath have been a difficult time for states and municipalities. High unemployment, steep asset price declines and falling property values all reduced tax revenues, leading to layoffs and cutbacks in municipal services. Five years into the recovery, many cities, municipalities and state governments have found it hard to regain the ground they lost during the downturn.

The financial crisis had another effect. It has brought to light the challenges surrounding public employee pensions and post-retirement health and insurance benefits, which had hitherto been masked by opaque or incomplete reporting. We will highlight some of these challenges in this report and will discuss the implications for investors in municipal bonds.

Municipal Market Overview

The municipal bond market is small in relation to the overall bond market. As of Q2 2014, there were $3.661 trillion of municipal bonds outstanding, representing 9.6% of the $38.187 trillion aggregate US bond market. However, the favorable tax treatment of municipal bonds makes them a preferred investment for higher income taxpayers and 71% of all outstanding municipal bonds currently are held by individuals, both directly and through money market and mutual funds:

Chart 1. Holders of US Municipal Securities
$billions as of June 30, 2014

Households	$1,602.40	43.8%
Mutual Funds	$1,009.50	27.6%
Banking Firms	$455.70	12.4%
Insurance Companies	$472.60	12.9%
Government/Other	$121.10	3.3%
Total	**$3,661.30**	**100.0%**

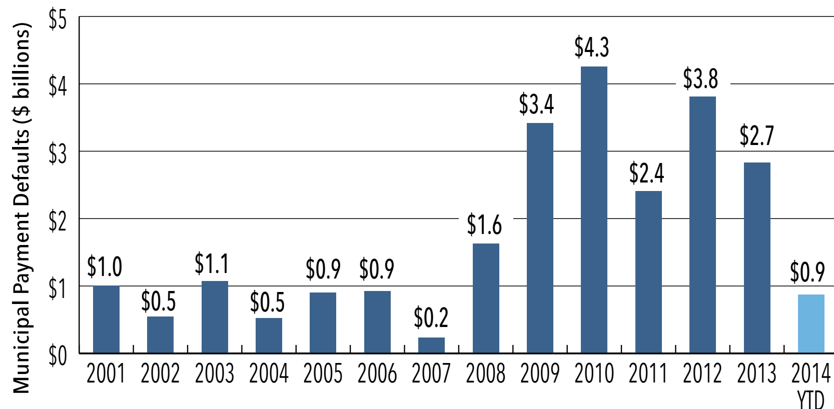
Source: Securities Industry and Financial Markets Association, sifma.org

The market is highly fragmented, with over 55,000 issuers, comprising states, cities and counties, plus myriad state and local government agencies and authorities that issue specific purpose bonds. Adding a further layer of complexity, the market is subject to extensive variations in rules and regulations, both at the state and local level. Thus, unlike the corporate bond sector, where different bonds can be compared across common characteristics such as interest rate, credit rating and maturity, comparisons in the municipal sector are more difficult. Municipal bonds with similar criteria may have very different provisions specific to the issuer or jurisdiction.

Municipal Market Update

Municipal securities have ranked second to US Treasurys in terms of their perceived investment risk. The only state to default on its debt was Arkansas in 1933, during the Great Depression. From 1970 to 2012, there were 73 defaults of rated municipal bonds. Hospital and housing project bonds accounted for 68 defaults, with only five defaults among city and county governments. Since rated issuers are a self-selected group, it is not surprising that the default rate jumps when unrated issuers are included—a combined 2,521 defaults from 1970 to 2011, compared to the 73 defaults for rated issuers. The majority of unrated issues tend to be small, regional or local offerings; hence, the higher default rates are not a major concern in the larger, more liquid rated market. (Appleson, Parsons & Haughwout. "The Untold Story of Municipal Bond Defaults." *Liberty Street Economics, FRB New York*. Aug 2012). And as tax revenues have risen and economic conditions have improved over the past five years, defaults have reverted to pre-crisis levels:

Chart 2. Municipal Defauls

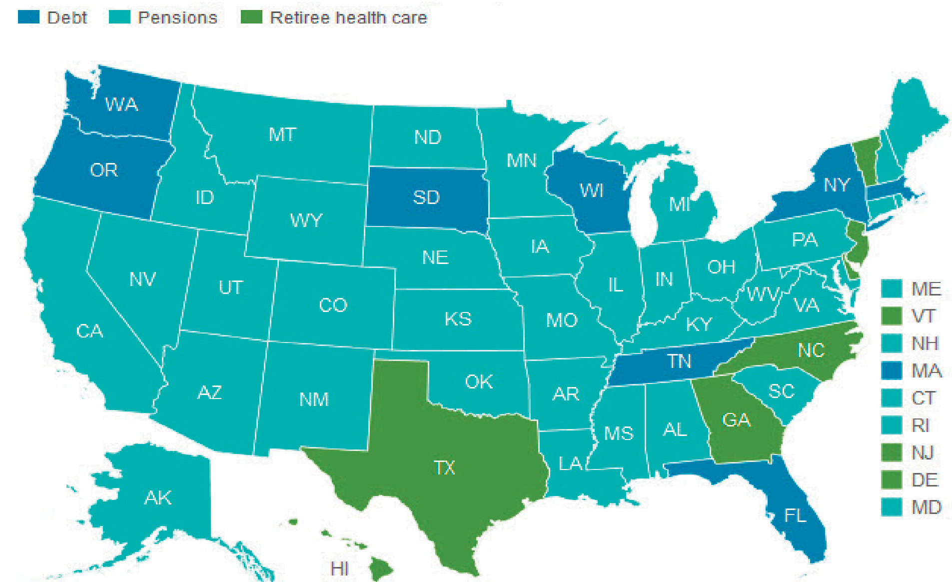


Source: Municipal Market Update, Nuveen Asset Management, September 30, 2014

Municipal Obligations

Historically, debt raised by states and municipalities was used to fund infrastructure and operating costs for essential services such as roads, schools, fire protection and public safety. Now an ever growing portion of state and municipal budgets is being consumed by retirement costs, both for current retirees and current employees. As shown in the chart below, only eight states list general debt as their largest obligation. Of the remainder, 35 states list state/municipal pensions and seven states cite retiree health benefits as their biggest obligation:

Chart 3. States' Largest Long Term Obligation FY2012



Source: Fiscal 50: State Trends and Analysis, Pew Charitable Trusts, August 19, 2014

How did the states get themselves into this mess? After all, with the exception of Vermont, all states are required to balance their budgets each year. As we will detail below, financially strapped municipalities are caught between two conflicting priorities: They must continue to deliver essential services while at the same time, they are under pressure to keep the promises they have made to retirees and workers. States and municipalities caught in a bind can use various ploys to balance budgets, such as reallocating funds between budget categories, borrowing against future revenues or diverting pension fund payments to the general budget to make up shortfalls.

Eighty-four percent of state and local government employees are covered by defined benefit pension plans, compared to only 20% of private employees. There are approximately 4,000 state and local pension plans holding roughly $3 trillion in pension assets. Plans range from very large, such as CalPERS and CalSTRS, to very small, local plans.

A number of factors have contributed to the pension underfunding. First, pension contributions are based on actuarial estimates of projected liabilities and portfolio returns. Weak market returns in recent years led to a shortfall in plan assets relative to their funding estimates. Second, instead of making the annual required contributions recommended by their actuaries, many states funded pension contributions based on their prevailing cash flow needs or some statutory amount decided by the state legislature. Third, states have used pension holidays to skip required payments. Some did so following periods of good returns, while others diverted cash to maintain essential services during a budget crunch. New Jersey is a special case, where the state slashed payments or skipped contributions altogether over a 17-year period.

Fourth, lawmakers boosted benefit packages in various ways that led to the current underfunding. During lean times, future retirement benefits were raised in lieu of a salary increase. Another common practice was spiking, where employees were allowed to work extra overtime in the period leading up to retirement and have the overtime added to their final year salary, increasing the base for their pension payout. They were also permitted to cash in accumulated sick leave, vacation pay and other benefits to help boost the final salary figure. With no cash outlay, the true cost of these benefits was hidden. While some of these actions were deliberate, we also acknowledge that most legislators are not well versed in finance and accounting matters, and may be overwhelmed by the number and complexity of issues they have to work on at any given time.

In addition to pension benefits, public employees have access to post-retiree health care, life insurance and other benefits lumped together as Other Post-Employment Benefits, or OPEB. Unlike pensions, these benefits are funded on a pay-as-you-go basis and most jurisdictions have set aside less than 5% of the OPEB liability, compared to the 60% to 70% funding for pension liabilities. Also, unlike pensions, OPEBs are not considered to be constitutionally protected.

Although most private pension plans have been terminated in favor of 401k plans over the last 30 years, almost all public plans remain in place. This is due in part to the widespread perception that public pensions enjoy a high degree of constitutional protection and partly to the strong influence of public sector unions on state legislatures. As a result, not only have public sector pensions survived, but they have benefited from many sweeteners and enhancements that have raised benefit costs to the point where the unfunded pension liabilities are consuming a larger and larger portion of state revenues, forcing states to cut back on basic services in order to balance their budgets.

With heightened scrutiny from investors and ratings agencies, these tactics are becoming harder to pull off. States have now woken up to the true cost of these enhanced benefits and 45 states have tried to institute some measure of pension reform since 2009. And yet, just last month, CalPERS, the nation's biggest pension plan, approved 99 types of specialty pay for pension calculations for California public workers, in direct defiance of the Public Employees' Pension Reform Act passed in 2012. (Summers, Adam. "99 Ways to Spike a Pension." *Orange County Register*. 5 September 2014).

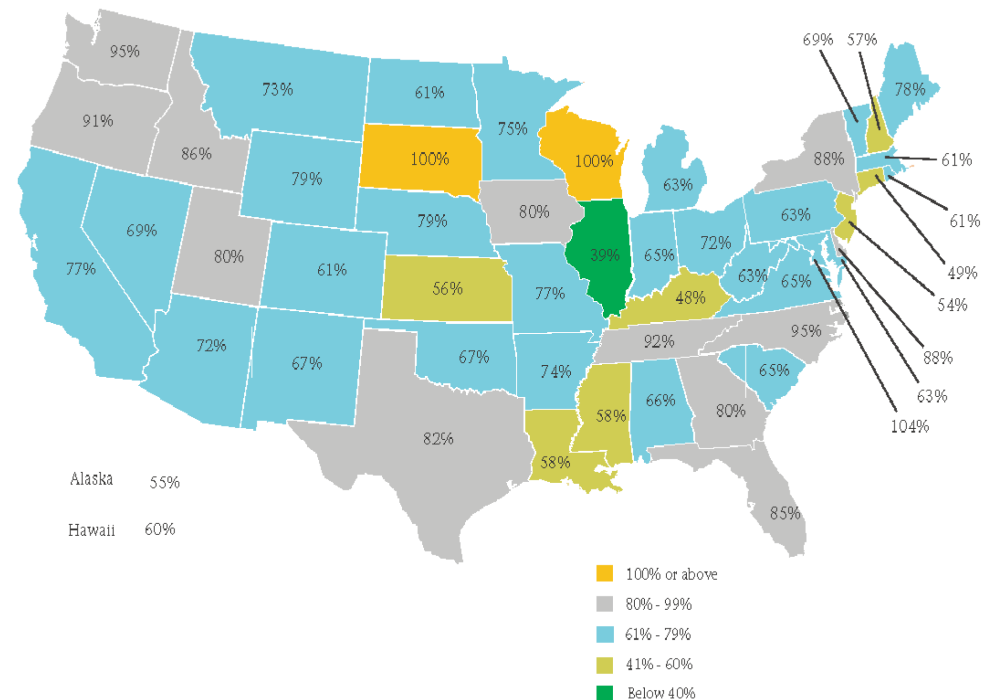
According to the National League of Cities, of the 10 critical imperatives facing cities in 2014, #1 is the fragile fiscal health of its members. In 2013, member cities reported their fiscal health was on the mend; this year, members indicated that high unemployment, uncertainty about federal and state actions, and long term pension and health benefit obligations, all constrained their fiscal outlook. The other four issues in the top five – deteriorating transportation infrastructure, the shrinking middle class, inadequate access to higher education and the need for affordable housing – are all affected by the fragile fiscal health factor. (“The 10 Critical Imperatives Facing Cities in 2014.” *National League of Cities.* 12 Dec 2013).

One important measure of financial health is liquidity. Prior to the financial crisis, states had a median financial cushion of 41 days. This year, states reported a median liquidity reserve of 23 days, with wide variations across the nation: Alaska, Wyoming, North Dakota and West Virginia have a cash cushion of at least 100 days, while Arkansas, Illinois, Pennsylvania and New Jersey have cash reserves below 10 days. (“Fiscal 50: State Trends and Analysis.” *Pew Charitable Trusts*. 19 Aug 2014).

Plan Funding Levels

Plans have usually been considered adequately funded at the 80% threshold. The Pew Charitable Trusts reported that, state pensions were 72.3% funded overall, but that retiree health benefits were only 6.1% funded. (“States’ Fiscal Health.” *Pew Charitable Trusts*. 19 Aug 2014). Again, there is wide variation across the nation: Wisconsin and South Dakota are the only states with fully funded pension plans. In 2013, four states were funded 90% or better – North Carolina 95%, Washington 95%, Tennessee 92% and Oregon 91%. Another 10 states were 80% funded or better and a further 20 states were funded at the 75% level. At the bottom, the worst funded states were Alaska 55%, New Jersey 54%, Connecticut 49%, Kentucky 48% and Illinois 39%.

Chart 4. State Funding Levels



Source: 2014 State Pension Funding Review, Loop Capital Markets, September 10, 2014

According to fund manager BlackRock, when heavy pension liabilities are combined with a weak, or weakening, credit profile for the bond issuer, this should be a red flag for investors, who should ask three crucial questions:

1. Does the state or city in question have a funded pension rate below 60%?

2. Has the state/municipality issued pension obligation bonds to fund that gap?

3. Does that state/municipality also have municipal debt outstanding?

Funding levels below 60% suggest that the plan will have difficulty meeting its obligations. If the municipality has issued pension obligation bonds, that is a warning sign that it has insufficient cash to meet its funding needs. And the risk is heightened if the issuer invests the borrowed funds into the market in hope of a higher return.

If the answer to all three questions is yes, that is an indication of pension-induced stress, especially when accompanied by factors such as declining population, low per-capita income, high unemployment and high foreclosure rates. (Hayes, Peter. "When Pension Pain Signals Bigger Ills: Three Symptoms to Look For." *BlackRock Municipal Bonds Group*. 10 Mar 2014).

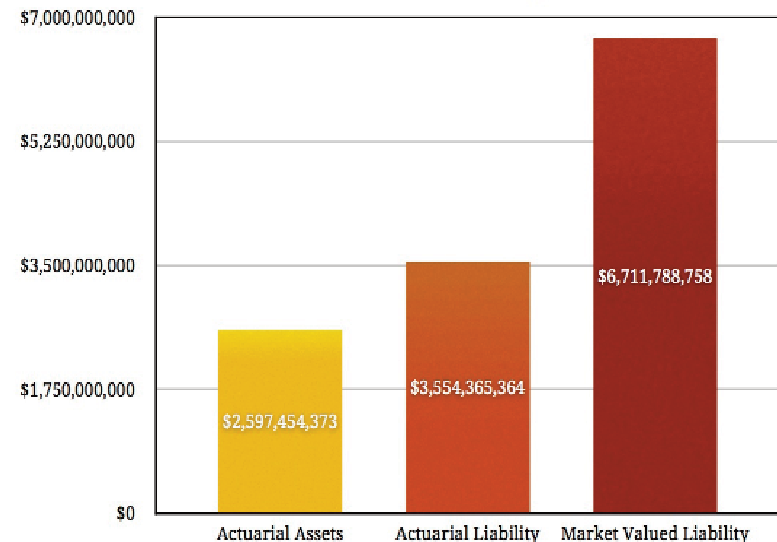
Calculation of Pension Liabilities

Public plans have customarily calculated the present value of their pension liability by discounting the expected cash flows at a rate equal to the expected return on their investments. This approach provides an estimate of how much money has to be invested at the expected rate of return in order to cover future payments to retirees. If plans were fully funded, this approach would provide an accurate estimate of the liability.

The majority of public plans use rates of return averaging 7.5% to 8%. However, studies have shown that even at this high rate, many plans are chronically underfunded and the high return assumption substantially understates the true magnitude of the liability. The Congressional Budget Office highlighted this issue in a 2011 report that showed how the aggregate FY2009 funding shortfall came to $0.7 trillion when discounted at an 8% expected rate of return, grew to $1.6 trillion when discounted at 6%, and jumped to $2.9 trillion when discounted at 4%.

It is now commonly accepted that unfunded pension liabilities are a serious problem for states and municipalities. Not so long ago, the extent and impact of underfunding was masked by opaque reporting and tactics such as cost shifting and smoothing. The severe decline in pension plan assets during the global financial crisis helped raise concerns about their ability to meet future plan obligations. The slow recovery in plan assets following the downturn did not help in allaying these concerns.

Moody's Investor Services has adopted the Citibank Pension Liability Index rate as a more realistic yardstick to calculate liabilities. This rate is currently 4.32%, compared to the average 7.75% rate used by the public plans. As illustrated below, for a given liability (orange), lowering the discount rate significantly increases the liability (red) and highlights the shortfall relative to the pool of assets set aside to fund the liability (yellow).



Source: Cory Eucalitto, Promises Made, Promises Broken—The Betrayal of Pensioners and Taxpayers, State Solutions, September 3, 2013

To determine which states have the highest and lowest burdens, Moody's looks at the ratio of each state's adjusted net pension liability to overall state revenues (see Chart 6). For this purpose, Moody's recalculates the state's accumulated pension liability using the Citigroup Pension Liability Index (currently 4.32%) to discount the cash flows. By this measure, Illinois, Connecticut, Kentucky and Hawaii all have the burdens exceeding 200%, while at the other extreme, Wisconsin, Nebraska, New York and Tennessee all have ratios below 20%. For comparison, the median value is 63.9%.

Regulation and Reporting

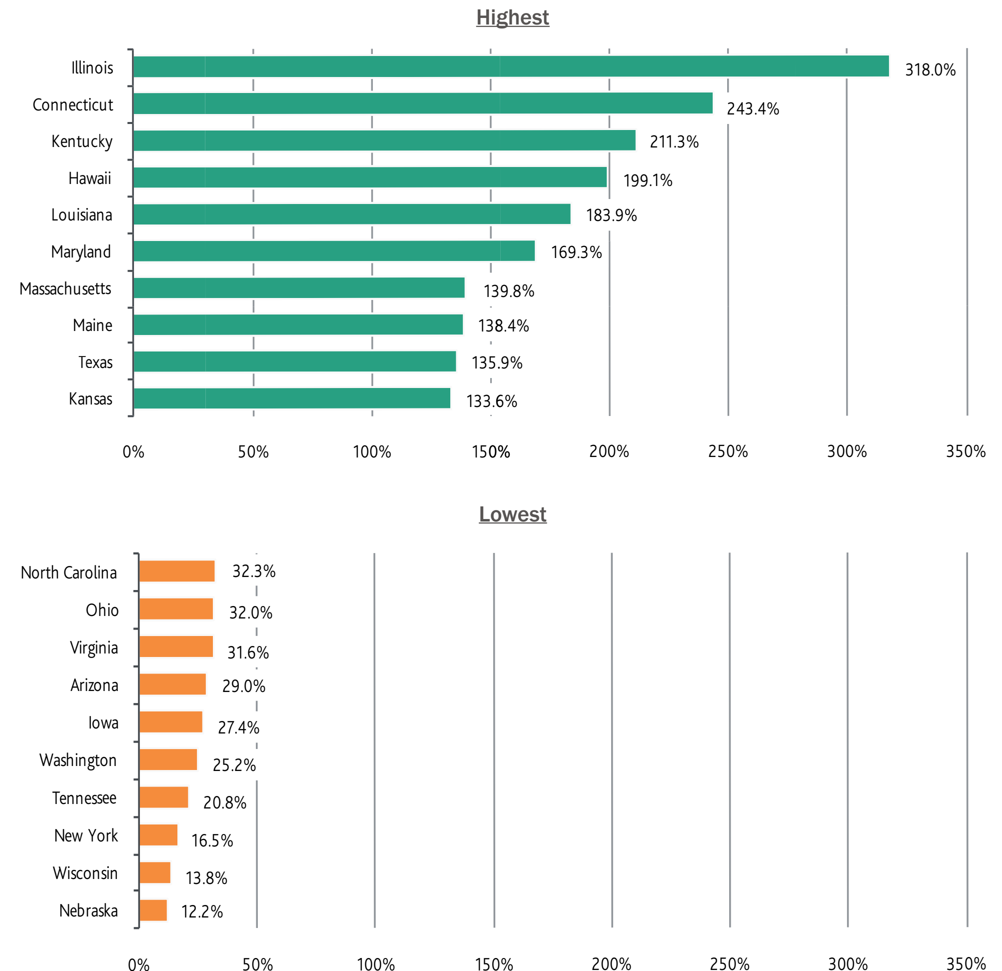
The Federal Employment Retirement Security Act of 1974 (ERISA) imposes strict funding requirements on private sector plans. In contrast, state and municipal plans are virtually free from federal oversight. In fact, while the federal government's own pension plan is fully funded each year, state and municipal plans are not subject to the same discipline. Annual contributions are often smaller than actuarially determined, or skipped entirely if the state needs the pension money to fund other services. No wonder that public plans find themselves in a chronically underfunded position.

Reporting for public plans is similarly lax compared to the private sector. Other than using guidelines issued by the Government Accounting Standards Board, public plans have broad latitude in how they report their results. Crucially, instead of recognizing investment gains or losses in a given year, most public plans use a process called smoothing to spread these gains and losses over multiple years; thus, it is difficult to ascertain the true funding status of the plan. Multi-employer plans often fail to report basic details such as required annual contributions, funding status and even total plan assets/liabilities.

Effective July 1, 2014, the Government Accounting Standards Board has issued new financial reporting (Statement #67) and accounting standards (Statement #68) for pension plans aimed at addressing some of the shortcomings identified above. While the new rules are not mandatory, state governments are required

Chart 6. Pension Burden by State

Adjusted Net Pension Liability as Percent of Governmental Revenues



Source: US State Pension Medians Increase in F2012, Moody's Investors Service, January 30, 2014

to use them if they want a clean audit report. As summarized in the December 2013 Bulletin, key provisions are as follows:

1. Asset smoothing is no longer permitted for accounting purposes, although it is allowed for funding purposes.

2. Plans are required to calculate, report and recognize on their financial statements the annual change in net pension liability at market value.

3. Cost sharing multi-employer plans (plans whose assets are available to any participant in the pooled program) are now required to report a pro-rata liability and expense proportional to their share of the total plan liability and expense.

4. If plan assets are sufficient to meet projected liabilities, plans are allowed to use the expected return to discount liabilities to a present value for accounting purposes.

5. If plan assets are insufficient to meet projected liabilities, plans are required to use a discount rate comparable to the AA-rated 20-year municipal bond index.

While the new standards address some of the reporting deficiencies that contributed to or exacerbated the underfunding, they also introduce a new element of volatility and complexity to pension reporting.

The Way Forward

Last month, Moody's Investors Service reported that the 25 largest US public pension plans face a $2 trillion funding shortfall. The plans in question averaged a 7.45% return from 2004 to 2013, which is comparable to their 7.65% expected return, and yet, their unfunded liabilities tripled over this period. How could this be? Beyond the huge negative impact of the market downturn, Moody's stated the shortfall was exacerbated by the compounding effect of the benefit accruals and additional years of service, together with the effect of issues such as irregular contributions, funding below recommended actuarial levels and pension spiking. (Chappatta, Brian. *Bloomberg*. 25 Sep 2014).

These magnified liabilities are now crowding out spending on education, road maintenance and other essential municipal services, setting the stage for a showdown between public employees, unions and taxpayers.

Options for Reform

Thirty years ago, the average ratio of workers to retirees stood at 2.8 to 1. Today, the ratio is 1.7 to 1 and declining. With fewer active workers supporting a growing retiree pool, the impetus for reform is clear.

Indeed, 45 states have made an attempt at pension reform since 2009. These measures include raising the retirement age, increasing the proportion of retirement costs paid by the employee, reducing cost of living adjustment escalators and rolling back supplemental benefits which do not have the same level of protection as pensions. Importantly, most of these changes have focused on reducing future benefits for newly hired employees. In very few cases, steps have been taken to introduce defined contribution plans to replace traditional defined benefit plans. The rollout of the Affordable Care Act is giving states an opportunity to reduce retiree health costs by shifting workers from state funded plans to the insurance exchanges.

However, it is evident that adjusting future liabilities will do little to improve the existing plan underfunding, which represent the biggest share of the liabilities. The options here are limited—municipalities can either raise taxes and/or broaden the tax base so they can contribute more to underfunded plans, or they have to consider rolling back benefits for current employees. Although states theoretically have unlimited ability to raise taxes, they are constrained in practice—beyond a certain point, taxpayers are likely to resist the imposition of

additional taxes, while an uncompetitive tax environment relative to neighboring states can encourage businesses to relocate or invest elsewhere. Hence, we expect that more and more states will be forced to revisit their current promises and the widespread perception that public pensions are constitutionally protected will be tested in the courts.

To put these issues in perspective, let us look more closely at Illinois. After years of chronic underfunding and poor fiscal management, Illinois has the worst unfunded liability and lowest credit rating of any state. Based on the findings of the Fiscal Futures project at the University of Illinois' Institute of Government & Public Affairs, the Volcker-Ravitch State Budget Crisis Task Force suggested various steps that Illinois could take to close the budget gap:

1. Raise the individual tax rate from 3.0% to 7.1% to close the gap solely with a tax increase.
2. Raise the state sales tax from 6.25% to 13.5% to plug the gap with sales tax revenues alone.
3. Cut spending by 25% across the board for all categories other than pensions, debt service and transportation if the hole is plugged solely with spending cuts.
4. Apply 100% of sales tax and income tax collections to interest payments if only debt is used to fill the budget gap.

A likely solution will incorporate all of these options, but these numbers highlight that the state will be forced to consider a range of unpalatable actions if it is serious about closing the gap.

A longstanding rationale for generous public pensions is to redress the supposed disparity between higher private sector pay and lower public sector pay. We have seen arguments from both sides, but a recent study by the American Enterprise Institute caught our attention for its thoroughness. AEI conducted a state-by-state analysis of public employee compensation relative to the private sector using a multi-variate regression model. Although public sector salaries compared unfavorably to those in the private sector, public sector employees came out ahead in overall compensation due to more generous pensions and retiree health benefits. If the impact of higher job security is factored in, public employees did even better. ("Overpaid or Underpaid? A State-by-State Ranking of Public Employee Compensation." *American Enterprise Institute Economic Policy Working Paper*. 24 Apr 2014).

Bankruptcy

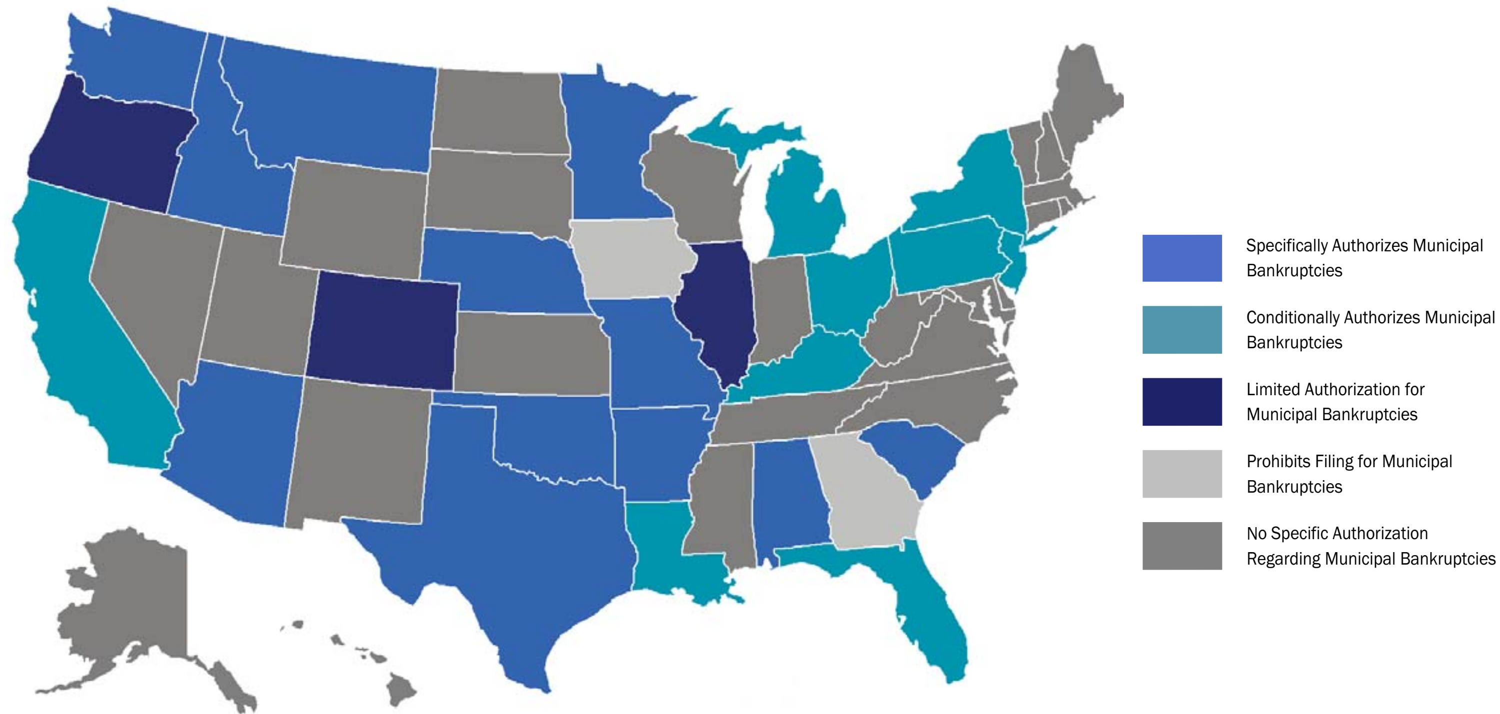
Chapter 9 of the US Bankruptcy Code is uniquely designed to allow public entities to reorganize their debts while continuing to provide essential services. Until recently, Chapter 9 was a rarely used option, but a growing number of distressed municipalities are now seeking bankruptcy protection.

It is important to qualify at the outset that as sovereign entities under the US Constitution, states are not entitled to bankruptcy protection. However, municipalities can seek Chapter 9 relief, subject to meeting the eligibility criteria. A distressed municipality has to obtain authorization from the state to proceed, after demonstrating that it is insolvent, unable to meet its obligations, and has made a good faith attempt to work with its creditors on a resolution.

As illustrated in Chart 7 on the following page, 12 states specifically authorize, and another 12 states conditionally authorize, municipal bankruptcy. Three states grant limited authorization and two states prohibit filing. The remaining 21 states provide no specific authorization. Municipalities in these 21 states are therefore ineligible to seek bankruptcy protection.

Seven states have specific language in their constitution explicitly protecting public employee pensions—Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan and New York. California, among other states, has taken the approach that state

Chart 7. State Authorization for Municipal Bankruptcy



Source: Municipal Bankruptcy: An Overview for Local Officials, State Budget Solutions, February 26, 2013

pensions are constitutionally protected. Recent judicial rulings suggest that the tide may be turning. In the Detroit and Stockton bankruptcies, courts have shown a willingness to treat pension obligations as another unsecured obligation of the state, meaning pensions could be subject to haircuts in the same way as other types of debt in bankruptcy. Also, a federal appeals court has allowed the City of Chicago to proceed with reducing subsidies for retiree health, despite a recent Illinois Supreme Court ruling that state retiree health benefits are protected under the state constitution.

Key Issues Arising from Chapter 9

Since 2008, 13 municipalities have filed for protection under Chapter 9 of the US bankruptcy code. Of these, five filings were rejected for reasons including lack of consent from the state. Among the remaining eight municipalities, here is a summary of key issues for the most significant cases:

1. Vallejo, CA (May 2008) – Due to corruption and a pliant city council, 74% of the city's budget was consumed by excessive salaries and

benefits to police and firefighters at the time of filing. The city's debt adjustment plan focused on reducing labor costs and retiree health benefits, but crucially, it did not address its largest liability, to CalPERS for pension funding. As a result, the city's finances remain tenuous.

2. Central Falls, RI (August 2011) – The State of Rhode Island played a key role in the Central Falls filing. Once it determined that the city was insolvent, the state passed legislation prioritizing payments to bondholders in an attempt to ring-fence Central Falls and protect other RI municipalities from a rise in borrowing costs. The main cause of the city's financial troubles was an onerous retirement cost burden and the reorganization plan was successful in cutting pension benefits.

3. Jefferson County, AL (November 2011) – The 2008 financial crisis damaged the AAA credit ratings of monoline insurers who had insured the county's debt. Without the insurance, the county saw a steep rise in financing costs on the debt. The county was also hurt by complex swap arrangements. When interest rates fell, the county found itself paying out more on 6.85% fixed rate swaps than it was receiving in floating rate income at near-zero rates. Rampant corruption in the sewer construction and financing activities of the project was also a factor.

4. Stockton, CA (June 2012) – The housing collapse caused city revenues to plummet, leaving the city unable to service its outstanding debt. In its reorganization plan, Stockton elected to lower payments to certain bondholders, while making CalPERS whole. As a result, CalPERS was supportive of the city's reorganization plan but the other creditors mounted a challenge to prevent CalPERS from getting special treatment. On October 1, 2014, the presiding judge ruled that Stockton can withdraw from CalPERS and restructure its pension liabilities. The judge's ruling is likely to have far-reaching consequences for other California municipalities, which is why it is being appealed by CalPERS.

5. San Bernardino, CA (Aug 2012) – Here, again, the housing collapse caused city revenues to decline. By 2012, 73% of the city budget was consumed by public safety salaries. Unlike Stockton, San Bernardino proposed to cut back on payments to CalPERS, its largest unsecured creditor along with payments to other creditors. CalPERS filed a legal challenge contesting the city's eligibility for bankruptcy protection on the basis that San Bernardino did not negotiate with its creditors. The city reached an interim agreement with CalPERS in June, but is still at odds with the police and firefighters union.

6. Detroit, MI (July 2013) – Detroit is the biggest municipality to file for protection. The proximate cause of the filing was the city's unwillingness to cut spending as its revenue base shriveled. The city's emergency manager has proposed treating Detroit's GO bonds as unsecured debt, allowing them to be repaid at a much lower rate. He also proposed selling off the city's art collection to raise cash. Fortunately, that proposal is now on hold. Another positive development was the bankruptcy judge's ruling that the city's pension obligations are not sacrosanct.

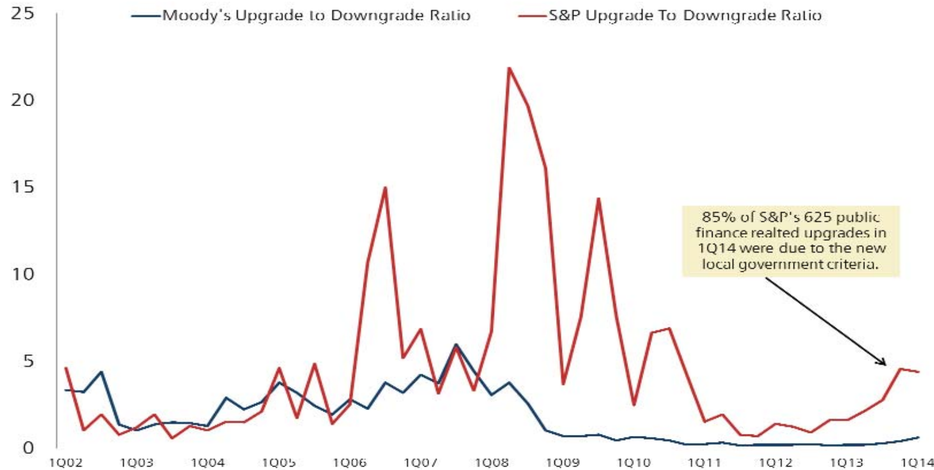
(Winegarden, Wayne. "Municipal Bankruptcies in America." *Pacific Research Institute.* Jan 2014. Friendly, Ed. "History of Municipal Bankruptcies Under Chapter 9." *edfriendly.blogspot.com.* Aug 2013. Canuto, Otaviano and Lili Liu, Eds. "Until Debt Do Us Part—Subnational Debt, In Solvency and Markets." *The World Bank*. 2013).

Ratings Agency Actions

As we mentioned earlier, Moody's changed its pension methodology in July 2012 to incorporate the Citigroup Pension Liability Index as a more realistic discount rate. In September 2013, Standard & Poor's announced its own changes in valuation methodology. Historically, the two agencies' ratings for a given issuer have been comparable, but now, we are seeing a significant divergence between the two (see Chart 8 on the following page).

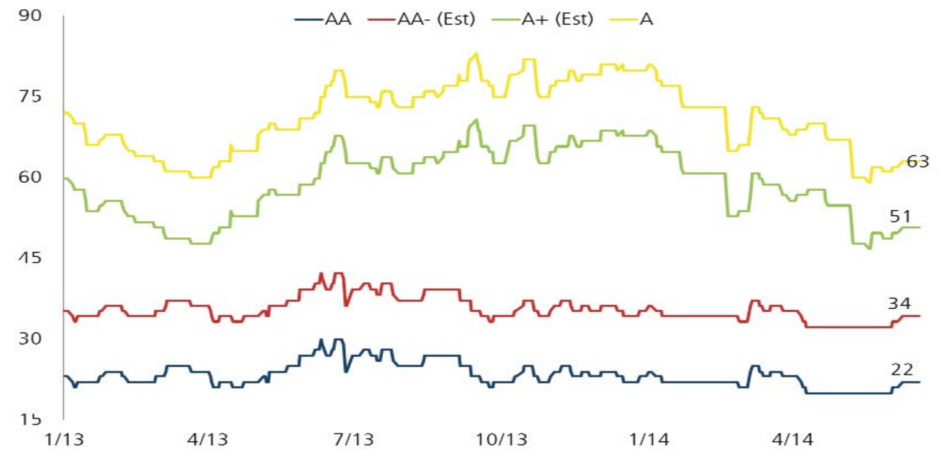
Municipal Market Update

Chart 8. Divergence in Municipal Bond Ratings by S&P and Moody's Updgrade : Downgrade Ratio



Source: Municpal Bond Market Monthly, Janney Capital Markets, July 14, 2014

Chart 9. Comparative Financing Costs (bps) by Issuer Credit Rating



Source: Municpal Bond Market Monthly, Janney Capital Markets, July 14, 2014

A number of bond managers have voiced concerns that Standard & Poor's is offering more favorable ratings to boost market share and they are focusing much more on the Moody's ratings. Given that both agencies were criticized for giving highly inflated credit ratings to bond issuers in the lead-up to the global financial crisis, this would be a disturbing development.

Higher ratings are valuable to issuers. As we see in Chart 9, higher-rated issuers enjoy a significant yield advantage over lower-rated issuers when it comes to financing costs. As the issuer ratings have diverged, there is a growing trend for issuers to come to market with just the higher rating. Due to the fragmentation and opacity of the market, investors may not even be aware that the same bond issue has received a lower rating from the other agency.

Regulatory Issues

Tower Amendment – The State Budget Crisis Task Force (aka Volcker-Ravitch Panel), led by Former Federal Reserve Chairman Paul Volcker has called for reforms to eliminate budgeting gimmicks and short term measures that obscure the actual financial conditions of states and cities. In its January 2014 report, the task force recommended Congress revisit the 1975 Tower Amendment, which exempts municipal issuers from SEC filings and disclosures. The Tower Amendment was originally passed by Congress out of respect for states' rights and concerns over the potential cost to local governments. The task force believes that the existing system of voluntary disclosure is ineffective and the Tower Amendment exemption deprives investors of material information about

the underlying condition of issuers facing fiscal distress or instability. (Final Report of the State Budget Crisis Rask Force, Jan 2014).

Basel III – As part of the Basel III guidelines to prevent a run on banks during crises, federal regulators announced that municipal bonds will be excluded from the definition of High Quality Liquid Assets that banks can use as collateral for liquidity coverage. Twelve percent of municipal bonds are held by banks and it is feared this rule will discourage banks from holding municipals. Trade association SIFMA is seeking a rule change to allow municipal bonds to be classified as High Quality Liquid Assets. (SIFMA comments to OCC, FRS, FDIC, Docket ID-OCC02013-0016, 31 Jan 2014).

Tax Treatment – The tax-favored status of municipal bonds is a perennial target for reduction or elimination. According to Bloomberg, this item cost the US Treasury $39 billion in the last budget year. The Obama Administration's 2015 budget calls for the tax-exemption to be capped at 28%, while House Ways and Means Committee Chairman David Camp (R-MI) proposed a reduction in the top tax rate to 25% in exchange for a 10% surtax on municipal bonds, phase-out of deductions on incomes over $450,000, and repeal of carried interest for private equity partners.

Sector Outlook

We believe the outlook is more positive going forward, for a number of reasons:

1. Thanks to the rating agencies and budgetary watchdogs, states and municipalities are finally acknowledging the true costs of their unfunded retirement liabilities and confronting the impact of these costs on their ability to provide basic municipal services to residents.

2. It is important not to lose sight of the big picture. The municipal market is a vital link between municipalities who need funding and investors looking to put money to work. While the retirement funding problems are serious, they are not going to destroy the market.

3. Putting aside the unfunded pension liabilities, overall credit quality has improved in tandem with the continuing improvement in economic conditions.

4. It may take additional Chapter 9 filings by strapped municipalities, but we believe that current employees and retirees will eventually agree to a give-back of some benefits in order to keep their plans solvent. Recent judicial rulings in Rhode Island, Michigan and California have opened the door to discussion about the inviolability of pension promises in other states.

5. Tax rates are likely to go up at the state and local level to cover some of the projected shortfalls. If so, municipal bonds will remain an attractive asset class for higher income taxpayers.

6. Although interest rates may remain on hold for longer, they will eventually rise and bond yields will improve. As more baby boomers enter retirement and look for ways to boost their income, the demand for municipals should remain strong.

7. Supply/demand characteristics are favorable to investors. The supply of municipal bonds continues to shrink, reflecting the impact of fiscal austerity. Issuance fell to $315.2 billion for calendar 2013, a 13% decline from 2012 and well below the 10-year average of $381.5 billion. Demand also fell in 2013, with a net $58.5 billion in outflows, mainly during the "taper tantrum." As sentiment reversed, the sector experienced positive inflows of $10.2 billion in the first half of 2014. ("Municipal Bond Credit Report." *SIFMA*. 4Q2013 and 2Q2014).

8. Although today's municipal yields are below 2013 yields in absolute terms, they are still attractive on a relative basis as overall bond yields are lower in 2014.

Municipal Market Update

Portfolio Implications

1. Given the fragmented nature of the municipal market and the wide variations in terms and covenants, intensive research at the individual bond level is essential for protecting investors.

2. Diversification is key to reducing risk. Holdings should be diversified across geography, sector and maturity.

3. In the current environment, investors may be better off taking interest rate risk rather than credit risk. Investors should not chase higher yields at the expense of credit quality. If conditions deteriorate, a portfolio of higher quality bonds is preferable to a lower quality portfolio.

4. In the municipal arena, our managers suggest reducing exposure at the short end (1 to 3 years) and focusing further along the yield curve (5 to 7 years).

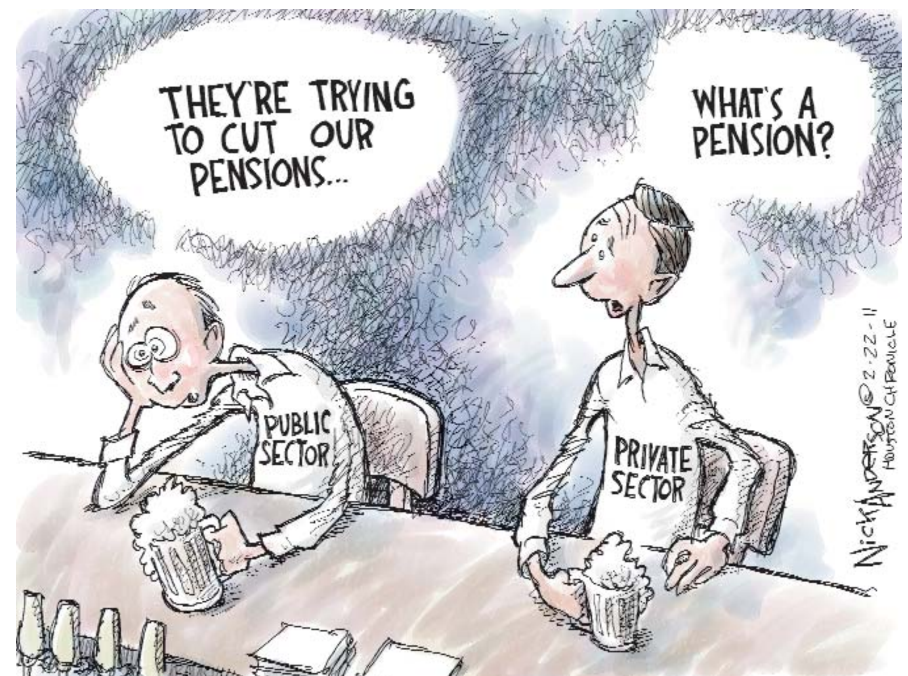
5. Investors should not necessarily eliminate exposure to states with high pension liabilities. If the state has a low overall debt burden and high per capita income, there is more room for the state to raise taxes and reform pensions than a state with a high debt load.

6. General Obligation bonds have traditionally been viewed as stronger credits as they are backed by the full faith and credit of the issuing municipality. In the current environment, revenue bonds tied to specific project revenues may be a safer choice for investors.

Conclusion

The municipal sector is under considerable pressure from the cost of servicing current and future retirement liabilities. Although it will take time and considerable effort, we believe it is in the interest of all parties to reach a compromise that alleviates some of the pressure on municipalities so they are not forced to seek protection by filing for bankruptcy.

From the examples we outlined above, the Chapter 9 process is less predictable than in the corporate world. However, it is clear that in a time of diminished expectations, judges no longer view public pensions as sacrosanct. If municipalities are allowed to abrogate their pension arrangements, employees and retirees could end up in a far worse position than if they reach a reasonable settlement with the states and municipalities.



Source: Nick Anderson, Houston Chronicle, February 22, 2011

Third Quarter Performance Summary

Asset Class	Benchmark	3Q14 Return	YTD Return	Performance Summary
Cash	Citi 3-month T-bill	0.01%	0.03%	Cash yields continue to remain at historical lows.
Domestic Gov't / Agency	BC U.S. Gov't & Related 5-7	-0.05%	4.30%	Hawkish comments in the FOMC minutes caused Treasury short yields to rise and long yields to decline. Agency securities benefited from diminishing supply and rising demand as yields rose.
Domestic Tax-Exempt	BC Municipal Bond 5-Year	0.79%	3.10%	Widening credit spreads helped the performance of municipal bonds. Lower quality bonds outperformed higher quality bonds. High yield municipals benefited from strong returns on Puerto Rican debt after PREPA and bank creditors agreed to extend credit lines into 2015.
TIPS	BC TIPS	-2.04%	3.67%	TIPS yields turned negative in Q3, amid further moderation in inflation expectations and Fed musings that inflation had fallen too far below its 2% target.
Investment-Grade Debt	BC Inv. Grade Intermediate	-0.14%	3.47%	Rising M&A and buyback activity led to strong new issuance activity. Refinancings also rose, as companies also sought to lock in low borrowing rates.
High-Yield Debt	BC High-Yield Intermediate	-1.95%	3.01%	Returns were hurt by a combination of higher yield spreads and increased outflows as investors reassessed their exposure to high yield dent. Conversely floating rate strategies benefited from rising yields.
Global Bonds	Citi World Gov't Bond Index (Hedged)	-3.78%	1.03%	Returns were affected by the strengthening of the dollar versus the euro and yen as the ECB and BoJ undertook further easing to counteract the slowdown in their respective areas.
Emerging-Markets Debt	Morningstar EM Composite Bond Index	-1.10%	6.61%	Q3 saw further divergence between hard currency and local currency debt, with local currency debt underperforming hard currency debt due to the surging dollar.
Large-Cap Equity	S&P 500	1.13%	8.34%	After hitting all-time highs earlier, the S&P 500 retreated late in the quarter, due to worries about weakening economic data, geopolitical conflict and strengthening dollar.

Third Quarter Performance Summary (Continued)

Asset Class	Benchmark	3Q14 Return	YTD Return	Performance Summary
Small/Mid-Cap Equity	Russell 2000	-7.36%	-4.40%	Uncertainty over weak economic growth and rising interest rates caused investors to move out of small cap stocks into higher quality large cap stocks with more stable revenue and profitability bases.
International Equity	MSCI EAFE	-5.75%	-0.81%	Sector performance was hurt by a combination of factors—deflationary concerns and falling growth in Europe; the impact of pro-democracy protests on the Hong Kong economy and the effect of falling commodity prices on the Australian and Canadian economies.
Emerging-Markets Equity	MSCI EM	-3.38%	2.56%	Emerging markets were hurt by concerns over tighter US monetary policy and rising geopolitical instability. Russian markets sank 15% as economic sanctions took effect. Brazilian stocks fell 9%, with the economy posting a second consecutive quarter of negative growth ahead of the Oct presidential election.
Real Estate	DJ Composite REIT Index	-3.70%	9.83%	Weak REIT performance in Q3 did not reflect strong demand across the board, particularly in the commercial, retail, industrial and multi-family segments.
Commodities	DJ UBS Commodity Index	-11.84%	-5.61%	Commodity and natural resource prices fell further in Q3, amid continued weak demand in China and emerging markets. Rising US energy production helped keep oil prices weak. Gold prices retreated further, despite rising global tensions.
Private Equity	S&P Listed Private Equity	-6.87%	-2.83%	Although listed PE stocks posted negative returns, PE firms reported continuing strong business conditions for the sector and brisk sales of portfolio companies at attractive prices.
Hedge Funds	HFRX Global Hedge Fund Index	-0.57%	1.18%	Weak equity, fixed income and commodity markets took their toll on the sector, particularly on equity hedged and event driven strategies. Short bias and macro strategies benefited from weakness in the broader markets.

Source: Bloomberg; Data as of 9/30/2014

Third Quarter Market Summary

US Equity Benchmarks	Price	1Q14	2Q14	3Q14	YTD	Annualized 1-Year	3-Year	5-Year	10-Year
Dow Jones Industrial	17042.90	-0.15%	2.83%	1.87%	4.60%	15.29%	19.02%	14.84%	8.15%
Nasdaq Index Composite	4493.39	0.84%	5.32%	2.24%	8.58%	20.67%	24.70%	17.62%	10.30%
S&P 500	1972.29	1.81%	5.23%	1.13%	8.34%	19.72%	22.98%	15.69%	8.11%
Russell 1000 (Large Cap)	1096.43	2.05%	5.12%	0.65%	7.97%	19.01%	23.24%	15.90%	8.45%
Russell 1000 Growth	921.05	1.12%	5.13%	1.49%	7.89%	19.15%	22.45%	16.50%	8.94%
Russell 1000 Value	985.22	3.02%	5.10%	-0.19%	8.07%	18.88%	23.94%	15.25%	7.82%
Russell Mid Cap	1575.93	3.53%	4.97%	-1.66%	6.86%	15.82%	23.81%	17.18%	10.29%
Russell Mid Cap Growth	708.47	2.04%	4.37%	-0.73%	5.72%	14.42%	22.73%	17.11%	10.19%
Russell Mid Cap Value	1609.21	5.21%	5.62%	-2.65%	8.19%	17.44%	24.76%	17.24%	10.13%
Russell 2000 (Small Cap)	1101.68	1.12%	2.05%	-7.36%	-4.40%	3.94%	21.27%	14.28%	8.16%
Russell 2000 Growth	657.25	0.49%	1.72%	-6.13%	-4.05%	3.79%	21.93%	15.50%	9.00%
Russell 2000 Value	1399.81	1.77%	2.38%	-8.58%	-4.74%	4.12%	20.61%	13.02%	7.22%
S&P GICS Sectors	**Weight**								
Consumer Discretionary	9.6%	-2.80%	3.50%	0.26%	0.86%	11.77%	26.27%	21.45%	9.56%
Consumer Staple	11.5%	0.51%	4.65%	1.95%	7.23%	16.52%	18.21%	15.40%	10.70%
Energy Sector	11.4%	0.79%	12.09%	-8.62%	3.24%	11.86%	16.88%	12.46%	11.24%
Financials	14.6%	2.61%	2.30%	2.33%	7.42%	18.52%	27.64%	11.03%	0.19%
Health Care	13.0%	5.81%	4.51%	5.45%	16.62%	28.42%	28.84%	19.74%	10.40%
Industrials	10.5%	0.14%	3.85%	-1.09%	2.87%	16.78%	24.83%	17.25%	8.12%
Information Technology	19.4%	2.28%	6.51%	4.77%	14.13%	29.27%	22.31%	16.02%	9.71%
Materials	3.5%	2.86%	5.60%	0.23%	8.87%	20.48%	21.96%	13.23%	8.71%
Telecommunication Services	3.0%	0.47%	3.78%	3.07%	7.47%	13.35%	15.21%	13.99%	7.82%
Utilities	3.6%	10.09%	7.78%	-3.96%	13.95%	17.13%	12.26%	12.13%	9.54%
Global Equity Benchmarks	**Price**								
MSCI World Index	1698.41	1.44%	5.06%	-2.02%	4.42%	12.91%	18.74%	11.61%	7.87%
MSCI AC World x-USA	416.85	1.23%	5.23%	-2.17%	4.22%	11.99%	17.36%	10.76%	7.99%
MSCI EAFE	1846.08	0.88%	4.33%	-5.75%	-0.81%	4.94%	14.40%	7.26%	7.07%
MSCI EAFE Growth	1396.79	0.31%	3.62%	-5.43%	-1.71%	3.36%	13.87%	8.09%	7.26%
MSCI EAFE Value	2985.30	1.45%	5.04%	-6.07%	0.09%	6.52%	14.88%	6.39%	6.81%
MSCI Emerging Markets	1005.33	-0.53%	6.72%	-3.38%	2.56%	4.64%	7.56%	4.79%	11.09%
MSCI BRIC	274.23	-2.89%	7.97%	-3.15%	1.55%	3.27%	5.64%	1.20%	10.54%
Nikkei 225	16173.52	-8.24%	2.35%	7.26%	0.74%	13.66%	25.22%	11.85%	5.80%

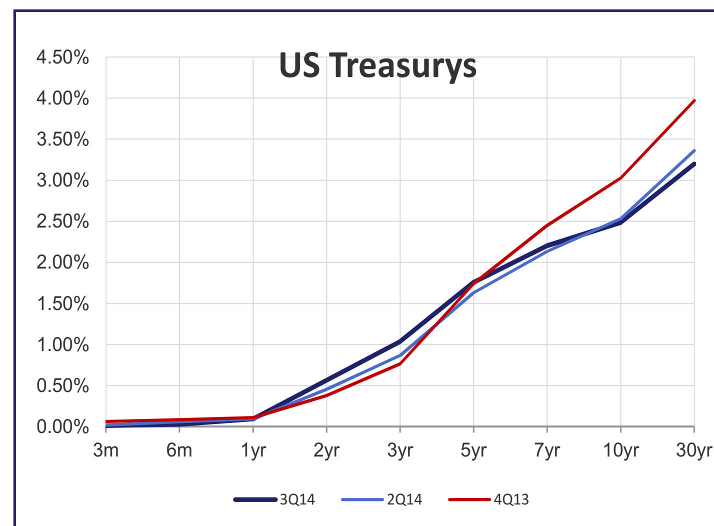
Global Equity Valuation Summary	2Q14	3Q14	QoQ
S&P 500			
Price	1,960.23	1,972.29	12.1
Trailing P/E	17.8	17.9	0.1
Est P/E	16.6	16.5	-0.1
Trailing 12m Earnings	110.4	110.2	-0.2
Est Forward 12m Earnings	118.1	119.3	1.3
Implied 1yr Earnings Growth	7.0%	8.3%	1.3%
Russell Mid Cap			
Price	1,608.70	1,575.93	-32.8
Trailing P/E	23.2	22.6	-0.6
Est P/E	20.2	19.8	-0.4
Trailing 12m Earnings	69.3	69.7	0.4
Est Forward 12m Earnings	79.7	79.7	0.0
Implied 1yr Earnings Growth	15.1%	14.4%	-0.7%
Russell 2000			
Price	1,192.96	1,101.68	-91.3
Trailing P/E	59.9	50.8	-9.1
Est P/E	27.7	26.0	-1.8
Trailing 12m Earnings	19.9	21.7	1.8
Est Forward 12m Earnings	43.0	42.4	-0.6
Implied 1yr Earnings Growth	116.1%	95.5%	-20.5%
MSCI EAFE			
Price	1,972.12	1,846.08	-126.0
Trailing P/E	15.3	15.1	-0.2
Est P/E	14.1	13.8	-0.3
Trailing 12m Earnings	117.1	111.6	-5.5
Est Forward 12m Earnings	140.2	134.1	-6.2
Implied 1yr Earnings Growth	19.7%	20.1%	0.4%
MSCI EM			
Price	1,050.78	1,005.33	-45.4
Trailing P/E	11.4	11.2	-0.2
Est P/E	10.5	10.3	-0.2
Trailing 12m Earnings	81.5	79.4	-2.1
Est Forward 12m Earnings	100.0	97.6	-2.4
Implied 1yr Earnings Growth	22.78%	23.0%	0.2%

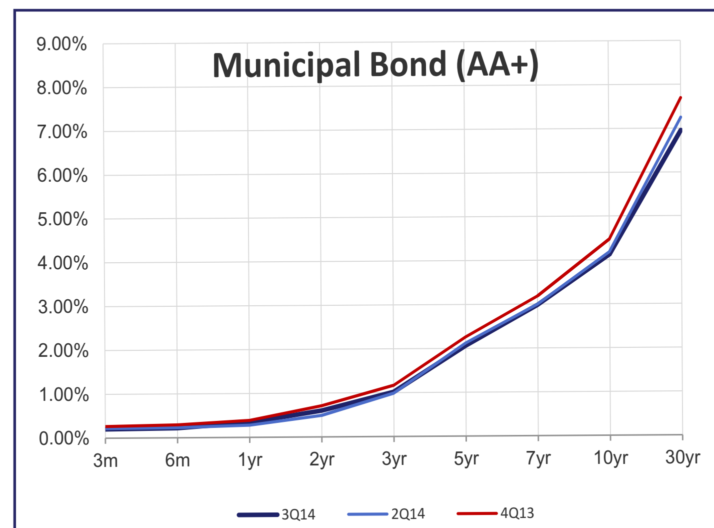
Source: Bloomberg; Data as of 9/30/2014

Third Quarter Market Summary (Continued)

		1Q14	2Q14	3Q14	YTD	Annualized 1-Year	3-Year	5-Year	10-Year
Interest Rates	**Yield**								
Prime Rate	3.25	0.00	0.00	0.00	0.00	0.00	0.00	0.00	-1.50
3m Treasury Bill	0.02	-0.01	-0.01	-0.01	-0.05	0.01	-0.01	-0.09	-1.69
US LIBOR 3m	0.24	0.00	0.00	0.00	-0.01	-0.01	-0.14	-0.05	-1.78
US Treasury 3m	0.02	-0.02	-0.02	-0.02	-0.05	0.00	0.00	-0.12	-1.69
US Treasury 10yr	2.52	-0.01	-0.01	-0.01	-0.52	-0.12	0.60	-0.79	-1.62
US Treasury 30yr	3.20	-0.16	-0.16	-0.16	-0.77	-0.49	0.28	-0.85	-1.70
Fixed Income									
Citi 3-month T-bill		0.01%	0.01%	0.01%	0.03%	0.04%	0.05%	0.08%	1.51%
BC U.S. Gov't & Related 5-7		1.99%	2.32%	-0.05%	4.30%	4.26%	2.80%	4.80%	0.00%
BC Municipal Bond 5-Year		1.00%	1.28%	0.79%	3.10%	3.96%	2.78%	3.54%	4.04%
BC TIPS		1.95%	3.81%	-2.04%	3.67%	1.59%	1.34%	4.48%	4.63%
BC Investment Grade Intermediate		1.74%	1.84%	-0.14%	3.47%	4.32%	4.55%	5.58%	5.01%
BC High Yield Intermediate		2.83%	2.17%	-1.95%	3.01%	6.64%	10.80%	10.18%	8.01%
Citi World Gov't Bond Index		2.66%	2.27%	-3.78%	1.03%	-0.07%	-0.51%	1.58%	4.08%
Morningstar EM Composite Bond Index		3.01%	4.64%	-1.10%	6.61%	7.74%	7.39%	7.37%	7.87%
Real Estate	**Price**								
Dow Jones Composite REIT Index	220.05	7.76%	5.84%	-3.70%	9.83%	8.42%	11.29%	10.08%	2.05%
FTSE EPRA/NAREIT Europe	1792.09	5.92%	8.48%	0.33%	15.63%	20.31%	18.23%	12.45%	5.92%
Commodities	**Weight**								
DJ UBS Commodity Index		6.98%	0.08%	-11.84%	-5.61%	-6.62%	-5.40%	-1.45%	-2.52%
Energy	21.0%	4.19%	4.36%	-12.07%	-4.39%	-0.22%	-2.40%	-6.74%	-13.06%
Agriculturals	33.0%	16.50%	-9.98%	-18.05%	-14.06%	-18.25%	-8.14%	0.14%	-0.12%
Livestock	6.7%	16.35%	3.57%	16.33%	17.81%	15.76%	1.72%	3.90%	-6.16%
Softs	8.3%	21.34%	-6.92%	-9.61%	2.09%	-5.16%	-14.78%	-0.65%	-2.02%
Industrial Metals	20.2%	-4.56%	8.49%	-3.31%	-0.73%	-0.47%	-4.36%	-2.40%	2.94%
Precious Metals	10.8%	5.40%	3.78%	-11.28%	-2.96%	-12.51%	-12.00%	2.39%	8.43%
Private Equity / Hedge Funds	**Price**								
S&P Listed Private Equity Index	197.43	1.34%	2.96%	-6.87%	-2.83%	3.43%	23.79%	12.80%	5.56%
HFRX Global Hedge Fund Index	1240.01	1.11%	0.65%	-0.57%	1.18%	3.54%	3.61%	1.83%	1.21%
Currencies	**Price**								
ICE Dollar Index	85.94	0.08%	-0.41%	7.72%	7.37%	7.12%	3.04%	2.31%	-0.17%
Euro / US Dollar	1.26	0.19%	-0.56%	-7.75%	-8.09%	-6.62%	-1.92%	-2.91%	0.16%
Pound / US Dollar	1.62	0.63%	2.66%	-5.22%	-2.08%	0.17%	1.33%	0.29%	-1.11%
US Dollar / Yen	109.65	-1.98%	-1.84%	8.21%	4.12%	11.58%	12.48%	4.10%	-0.04%

Source: Bloomberg; Data as of 9/30/2014





Source: Bloomberg, HPM Partners. Reflects 5-year tenor, broad composite and generic returns.

Municipal bond yields are shown on a comparable, adjusted basis using a 35% tax rate.

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