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Perspectives

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Spring 2011

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Municipal Bonds: Still Safe Investments?

The general perception of municipal bond credit quality has suffered a decidedly negative shift in the eyes of many retail investors over the past several months. Reasonable concerns about the recession's impact on municipal budgets transformed to panic as a handful of alarmist analysts began to predict massive defaults, with one analyst famously calling for "50-100 sizeable defaults amounting to hundreds of billions of dollars" in a *60 Minutes* interview.

Such fantastic claims play well in the media, ensuring that they are repeatedly and widely broadcast. Inundated by these dire forecasts many individual investors understandably are concerned that the municipal bonds they once viewed as virtually riskless may turn out to possess quite a bit of risk. The truth, as usual, probably lies somewhere in the middle. In the meantime, some investors seem to be taking no chances – according to the Investment Company Institute there have been roughly \$40 billion of net new cash outflows from municipal bond mutual funds since October 2010.

Defenders of the municipal bond market do themselves a disservice by habitually quoting the miniscule historical default rate as "evidence" that municipals will be safe in the future. Any credibility this line of argument might have had was lost in the wake of the 2008 credit crisis when historically rare events occurred with regularity. Moreover it ignores the underlying issue – namely that budgets are stressed by depleted revenues and ballooning costs associated with funding promises *Continued on Page 3*

Market and Economic Review

One needs only to glimpse a few images of the aftermath of the recent Japanese earthquake and tsunami to appreciate the power of Mother Nature. The pictures of villages literally swept away and the tremendous toll inflicted on the inhabitants of the region are truly heartbreaking. While the tsunami has receded and aftershocks have subsided, as of the writing of this article, engineers continue to battle out of control nuclear reactors at the Fukushima Daiichi power plant.

On the Monday following the earthquake, world markets began a sharp three day sell off. In retrospect, much of the initial reaction appears to be the result of uncertainty and fear that the tragedy would disrupt a perceived fragile recovery in the global economy. Events playing out in the Middle East at the same time perpetuated these sentiments. However, just six days after the rapid 3.6% drop in the S&P 500, the market had regained everything it lost. The turnaround can probably be attributed to the realization that the disaster would not have as profound a long-term impact on the global economy as originally surmised. While short-term supply disruptions may materialize in some sectors, a review by Merrill Lynch contended that "assuming a dire scenario where Japan's GDP growth comes in flat for the full year, global GDP growth would only drop by 0.1%". Furthering this point, Bank Credit Analyst, a global research firm, estimates that Japan has contributed roughly 2-3% to global economic growth over the past five years. Thus, it seems unlikely that a slowdown in Japan could lead to a global recession. Moreover, Japan is a wealthy nation. Despite its high level of national debt, which JP Morgan estimates to be roughly 130% of GDP, Japan should be able to absorb the cost of rebuilding.

Back in the U.S., long desired economic growth seems to finally be taking root. Perhaps surprisingly to some, our economy has been growing, albeit slowly, since the third quarter of 2009. Most experts believe the first quarter of 2011 will be the seventh straight quarter of GDP growth. Of perhaps greater significance is the recent downward trend in unemployment. In February, unemployment dropped to 8.9%, falling below 9.0% for the first time since April of 2009. *Continued on Page 2*

Mutual Funds 101: Mechanics of Mutual Funds

Mutual Funds have quickly become one of the most popular investment vehicles in the United States. According to the Investment Company Institute 2010 Fact Book, 43% of all U.S. households owned mutual funds at the end of 2009, compared to only 6% in 1980. This growth can largely be attributed to the proliferation of employer sponsored retirement plans over the last several decades. Despite this tremendous popularity, the mechanics of mutual funds remain widely misunderstood.

Mutual Funds are portfolios of securities, mainly stocks, bonds, and money market instruments, whereby investors own a pro-rata share of the overall portfolio. Mutual funds provide benefits such as professional management, diversification, lower transaction costs, and liquidity. They are usually managed to satisfy specific investment objectives, such as growth, income, or stable value, and are usually measured against specific benchmarks, such as the S&P 500, EAFE, or Lehman Aggregate Bond Index. Actively managed mutual funds attempt to outperform their respective benchmarks, while passively managed mutual funds (index funds) attempt to replicate the performance of their respective benchmarks.

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Market and Economic Review

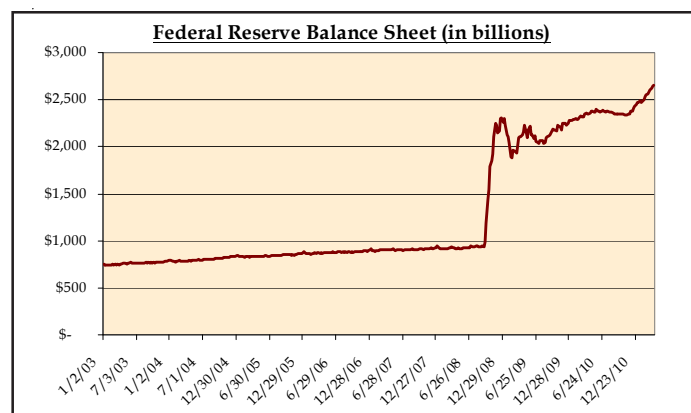
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However, while the U.S. and global economies appear to be on the mend, many economists are asking if the government went too far in propping up markets in the last recession. Many probably remember the first major action taken to combat the financial crisis in the waning days of 2008 – TARP. TARP (Troubled Asset Relief Program) was the much scrutinized “bailout” of the large national banks. While the program was originally authorized to purchase troubled assets from banks (up to \$700 billion worth), TARP funds were ultimately used to buy preferred stock from financial institutions as well as GM and Chrysler. Pundits have debated the merits of the program for nearly 2 ½ years, with both right and left-leaning commentators arguing for and against it. Meanwhile, the Treasury Department has been trumpeting the program’s success of late, proclaiming that through mid-March taxpayers had recovered \$244 billion of the \$245 billion disbursed to banks.

TARP certainly sounds like a success, or at least less of a failure than many predicted. However, many economists argue that an alternative much less publicized program is what truly rescued the banking industry. In what has come to be known as QE1 (Quantitative Easing 1), the Federal Reserve in 2009 injected roughly \$1.5 trillion of cash into the market, and used it to purchase troubled mortgage-backed debt owned by financial institutions. In essence, the Fed did what TARP was originally designed to do, without the \$700 billion cap and without a vote of Congress. Where did this \$1.5 trillion in “new” money come from? The Fed created it - electronically. As a result, the Fed now owns the very securities that threatened the existence of the banking industry back in 2008.

Historically, the Federal Reserve had maintained a relatively simple portfolio of between \$700 and \$800 billion of Treasury securities - an amount largely determined by the volume of dollars in circulation. However, thanks to QE1, the central bank increased its portfolio to nearly \$2.4 trillion by June 2010. Undaunted, and unsatisfied with the pace of economic recovery, the Fed embarked on yet a second round of easing late last year, now commonly being referred to as QE2. This second round of easing is expected to pump another \$600 billion of cash into the markets by mid-year 2011 and inflate the Fed’s balance sheet to roughly \$2.8 trillion.

With the economy recovering, it is this growth in money supply that is now seeding a new fear - inflation. Over the past couple of years, several forces have helped keep inflation in check, foremost of which were the recession and de-leveraging by consumers. However, those forces may be fading. As mentioned previously, the Fed has pumped trillions into the economy. But where is all



that money? Quite simply, much of it is being held by businesses as cash and short-term securities. By the second half of 2010, S&P 500 companies were holding a record \$2.5 trillion of cash on their books, or about 27% of corporate assets. In comparison, cash represented about 15% of the corporate assets of S&P 500 companies back in 2000.

While CEOs have offered many reasons for hoarding high levels of cash, such a strategy comes at a price. In the current interest rate environment, cash is earning virtually nothing, making the returns demanded by shareholders difficult to attain. Not surprisingly, Bloomberg reported that in the fourth quarter of 2010 capital spending increased by \$22.3 billion, dropping the cash in company coffers to about \$2.4 trillion. If corporate leaders buy into the prospect of real economic growth, this cash hoard will continue to be put to use in the form of buyouts, re-investment in plant and equipment, stock buybacks or higher dividends. All of these actions would be stimulative forces on the economy. And with a resurgent economy, consumers are likely to begin spending again, adding even more stimulative force. All in all, it is quite easy to envision an expansionary economic environment in which the two recent checks on inflation are removed ■

Municipal Bonds: Are They Safe Investments? *Continued from Page 1*

to retirees – to which the alarmists, to their credit, have drawn attention. However, they generally fail to acknowledge the structural positions of strength from which most state and local governments will confront these challenges in the sound bites they craft for the media. Investors need to understand these strengths because they frame a persuasive argument that the high quality segments of the municipal bond market can still be appropriate for conservative investors.

With all the talk about budget deficits, unemployment, and pension liabilities most people do not realize that the vast majority of municipalities do not currently have debt problems. According to a report from *FitchRatings* issued in November 2010, “The tax-supported debt of an average state is equal to just 3-4% of personal income, and local debt roughly 3-5% of property value. Debt service is generally less than 10% of a state’s or local government’s budget, and in many cases much less.” In addition, according to PIMCO, as of December 31, 2010 the weighted average maturity of municipal bonds outstanding was a lengthy 16.2 years. In comparison to the slightly less than five year average maturity for U.S. Treasury debt provides some context for just how long this really is. The longer term structure of municipal debt unmistakably helps to limit the refinancing risk faced by issuers and makes the overall debt burden that much more manageable.

Given that debt service represents such a small percentage of most budgets, there is no incentive for the majority of municipalities to hurt bondholders with defaults when it will not solve their problems. Their primary burden comes from paying for things like education, social services, and a broad array of municipal services. Thus, governments stand to gain very little by not paying their bonds and in doing so would risk limiting their future access to capital markets on reasonable terms.

Even in the rare case of municipalities seeking Chapter 9 (municipal bankruptcy) protection, the desire to retain access to capital markets has been a powerful force. In Chapter 9 proceedings, general obligation bonds that are not further secured by a revenue pledge technically can be treated as an unsecured claim subject to

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restructuring. However, as *The Bond Buyer* reports, even in a case like Sierra Kings Health Care District in Fresno County, California, the District continued to levy taxes to pay its general obligation bonds after it entered bankruptcy, because in the words of its bankruptcy attorney, Riley Walter, “the hope of the district is to preserve its ability to borrow in the future.” Another example comes from Vallejo, California which continues to service its certificates of participation (a bond structure usually consisting of lease payments by the issuer that are subject to annual

appropriation), albeit at a reduced interest rate, despite having no legal obligation to do so.

Though the bulk of the hard work is still ahead, state and local governments have begun repairing their budgets. Cost cutting measures have been introduced at all levels of government including reductions in headcount through layoffs and attrition and reductions in services like park maintenance, garbage pickup, and public transportation. Lawmakers in Michigan and Florida are considering proposals to allow municipal consolidations, eliminating duplication of services and employees. Illinois recently passed a substantial “temporary” tax increase and last year passed pension reform expected to reduce pension liabilities by at least \$220 billion over the next 35 years. Wisconsin may be close to overcoming

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legal challenges to its recent effort to increase the portion of health and pension costs paid by public employees and limit their collective bargaining rights. New Jersey governor Chris Christie is seeking substantial cuts to school state aid and is targeting public employee collective bargaining rights and benefits. The list goes on.

A somewhat measured intermediate-term forecast for the municipal bond market was released by a consulting firm founded by Nouriel Roubini (an economist not typically known for his rosy views). It states that there could be close to \$100 billion in defaults over the next five years and that “most of the defaults will occur among special revenue government projects and revenue-generating entities that aren’t considered viable.” It concludes, “Defaults will continue to be isolated events”. Indeed, *The Bond Buyer* estimates total municipal debt outstanding as of the end of 2010 to be roughly \$2.93 trillion. Thus, \$100 billion of defaults over five years would represent a cumulative default rate of 3.42%. According to Bloomberg, the Roubini report goes on to say that, “the \$100 billion figure for the next five years was a pessimistic calculation. At that amount, investor losses would be only about \$35 billion because of the historically high rate of principal repaid on distressed municipal bonds.”

Z&W has a similar opinion. Due to the stress facing state and local governments, default rates are likely to be elevated for some time. In the near-term municipalities have to deal with cyclical budget problems and in the long-term they must contend with their promises to retirees. Clearly, this is not a time to be complacent about credit risk! However, we believe that many municipalities have relatively light debt burdens, an assortment of policy options to improve their fiscal positions, and no compelling interest that would be served by defaulting on their bonds. Accordingly, we are comfortable recommending investments in high quality state and local general obligations as well as essential service revenue bonds, while maintaining our practice of avoiding the types of special revenue projects highlighted in Mr. Roubini’s report ■

Mutual Funds 101: Mechanics of Mutual Funds

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cap (>\$10-12 billion). With respect to style, equity mutual funds are typically regarded as “growth”, “value”, or “blend” based on management philosophy, valuation metrics, and growth rates of the companies they hold. Growth funds invest based on the premise of price momentum and continued innovation of the underlying companies. Value funds purchase shares of companies believed to be undervalued by the market, anticipating a reversion to intrinsic or fair value.

TYPES OF FUNDS - Equity mutual funds invest primarily in stocks and differ by average market capitalization, style, and sector of the stocks in which they invest. Market capitalization refers to the average size of the companies held by the fund, ranging from micro-cap (<\$300 million) to large

Fixed income funds invest in bonds and other fixed income instruments and generally differ by credit quality, duration, and tax status. While bond funds may be appropriate for some investors, Z&W believes that most investors are better served by owning laddered portfolios of individual bonds that are held to maturity. Bond funds are subject to the same risks as individual bonds; however bond funds may experience greater price volatility and potential losses during bear markets. During periods of rapidly rising interest rates, high inflation, or a credit crisis, bond fund managers may be forced to quickly unload positions at unfavorable bids in order to satisfy rampant redemptions from the fund, putting even more downward pressure on the price of the fund. Individual bond investors, on the other hand, have the ability to hold their bonds to maturity and ignore short term price fluctuations. In addition, individual bond portfolios may be customized to manage cash flow needs and target specific parameters like credit quality and duration.

TAXATION OF MUTUAL FUNDS - The price per share of a mutual fund is known as its Net Asset Value (NAV), which equals the market value of the portfolio less the liabilities of the fund divided by the number of shares outstanding. The NAV of the fund is determined at the close of each trading day based on the closing price of the assets held in the fund. All new investment or redemptions from the fund are priced at the closing NAV. Mutual funds must distribute at least 90% of their net investment income to shareholders in order to avoid taxation at the fund level. Consequently, investors pay taxes on distributions of realized capital gains and dividends for the year in which they are paid by the fund, regardless of whether or not they are reinvested.

On the payment date of income and capital gains distributions, the NAV is reduced by the amount paid. If the distributions are reinvested the investor has, in effect, made an additional purchase of shares with that tax lot having its own cost basis. The reduction to NAV and adjustment to cost basis is confusing and may cause investors to conclude that their funds are underperforming when this may not be the case. For example, on January 1, an investor buys 100 shares of Fund A at an NAV of \$25, resulting in a \$2,500 total cost basis. By December 30, the fund has appreciated 10.0% to \$27.50, resulting in a \$2,750 market value, and the fund announces that it will distribute realized capital gains of \$1.00 per share. The NAV is consequently drops by \$1.00 to \$26.50, reducing the investor’s market value to \$2,650, plus \$100 in cash. If the investor reinvests the distribution, additional shares are purchased at the reduced NAV, resulting in a new tax lot and an adjusted cost basis. When the shares are sold, the investor’s realized gain is based on the difference between closing NAV on the date of sale and the adjusted cost basis (see example).

MUTUAL FUND FEES & EXPENSES - Mutual funds have two principal costs borne by investors, sales charges and operating expenses. Sales charges are commissions paid by investors to the sales agent and come in various forms, such as front-end, back-end, and level loads. Z&W feels that investors are best served by avoiding these potentially sizeable costs entirely by investing in no-load mutual funds. Operating expenses are debited by the fund company to cover management expenses, distribution costs, and other expenses like legal, marketing, and accounting. Operating expenses are often described by the expense ratio - the total sum of the annual fees divided by the average market value of the fund throughout the year. Performance is reported net of all of these costs.

In our opinion, mutual funds provide a very effective way to access equity markets. They provide investors with numerous benefits such as daily liquidity, diversification, and professional portfolio management while maintaining a low cost structure and transparency not available in investments such as hedge funds or private equity. However, like any investment, it is important to know the risks and mechanics of the investment you are selecting ■

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Example: Adjustment to NAV & Cost Basis

	# Shares	NAV	Mkt Value
Purchase on January 1	100.00	\$25.00	\$2,500
Value on Dec. 30	100.00	\$27.50	\$2,750
Cash Distribution of \$1.00/Share on December 31:			
	# Shares	Adj NAV	Mkt Value
Market Value	100.00	\$26.50	\$2,650
Cash	---	---	\$100
Total Value	---	---	\$2,750
Reinvestment of Cash Dist on December 31:			
	# Shares	Adj NAV	Mkt Value
Tax Lot 1: January 1	100.00	\$26.50	\$2,650
Tax Lot 2: Dec. 31	3.77	\$26.50	\$100
Total	103.77	\$26.50	\$2,750
Resulting Adj to Cost Basis Due to Reinvestment:			
	# Shares	Unit Cost	Cost Basis
Tax Lot 1: January 1	100.00	\$25.00	\$2,500
Tax Lot 2: Dec 31	3.77	\$26.50	\$100
Total	103.77	\$25.05	\$2,600

Note: This example assumes no market value change on 12/31.