



Zemenick & Walker

Market Perspectives

An Investment Advisory Firm, Established in 1987

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Tax Exempt Muni Bonds: Invest with Caution

Investors have long looked to the equity markets for the accumulation of wealth. Yet, the past few years have been a testament to the volatility and risk associated with equity investing. Indeed, as equity market returns have fallen from the extraordinary, yet unsustainable days of the late 1990's, many investors are fleeing the stock market in search of a safe haven for their money.

Increasingly, these investors are turning to municipal bonds not only as a place to park their capital, but also as a place to earn highly coveted yields. Through August of 2002, investors dumped \$17.6 billion into municipal bond funds. This marks the largest inflow since 1993, and a 38% increase from 2001. In 2000, investors actually pulled \$13.7 billion from municipal bond funds, illustrating the dramatic shift in popularity. To meet the demand, mutual fund companies have created three dozen new municipal bond funds and 35 closed-end municipal funds in 2002 alone.

Why municipal bonds? The answer lies in a combination of their perceived safety, their exemption from federal taxes, and a resulting higher after-tax yield than U.S. Treasuries and Agencies. However, while municipal bonds are *tax-free*, they are not *risk-free*.

As mentioned earlier, investors have poured billions into municipal bonds. Yet with interest rates at historical lows (see *By the Numbers* page 4) any increase in interest rates will likely send bond prices

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Focus on the Economy

Defying the gloomy expectations of pessimists around the world, the U.S. economy has continued to demonstrate remarkable resilience. Most pundits have ceased to discuss the likelihood of a "double-dip" recession; instead the debate now focuses on the strength of the recovery. Looking at major economic indicators, there still appears to be cause for concern that the U.S. could relapse into recession, though many economists expect a steady recovery.

The continued strength of American consumers will be crucial to sustaining a meaningful long-term recovery. First the good news, consumer confidence rose in November from 79.6% to 84.1% and home sales have remained robust. Early reports for holiday shopping were good as well, with Wal-Mart reporting sales of \$1.4 billion on the day after Thanksgiving, a one-day record and a 14% increase over 2001. The November unemployment report dampened this positive news, as it rose higher than expected to 6% from 5.7% in October. However, it should be noted that unemployment is typically a lagging indicator and therefore not necessarily indicative of future conditions.

Despite the generally positive news about consumers, economists are worried that consumer spending may yet weaken due to the mounting levels of household debt. According to Bloomberg reporter Monee Fields-White, household borrowing "is rising at the fastest rate in almost 13 years, personal bankruptcies are at an all-time high, and mortgage foreclosures have reached a 30-year peak." If

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Milton Friedman, Nobel Prize winning economist*

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plummeting. And while falling prices may not be of concern to those who plan to hold their bonds to maturity, bond fund investors and investors who may need to sell bonds to raise cash could face significant losses. For example, when interest rates spiked in 1994 Merrill Lynch's long-term national municipal bond index experienced a 13.80% loss of capital.

With interest rates at 40 year lows, many investors are attempting to squeeze extra yield from their bond portfolios. The first and perhaps most risky of their yield-chasing strategies is the purchase

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of lower quality bonds. However, this strategy not only puts investors' income at risk, it also puts their principal on the line. As the economy continues to stumble, states and local municipalities face ever-tightening budgets. Due to record tax inflows during the 1990's, states built their reserves to a combined level of \$48.8 billion by 2000. According to the *Fiscal Survey of States* published by the National Governor's Association, by 2003, this reserve is estimated to dwindle to \$14.5 billion, with some states already experiencing shortfalls (California has a projected deficit of \$30 billion for 2003). The reason for the decline, quite simply, is that most state officials have not addressed the issues of expanding budgets and decreasing tax revenues. Currently, Standard & Poor's identifies ten states with negative outlooks, including California, Indiana, Kansas and Tennessee. These states, according to Standard & Poor's, run a high risk of downgrade. Additionally, local bond issuers face the same budget problems as state governments. In July 2001, Denver's Ocean Journey Aquarium, a non-rated issuer, defaulted on \$57 million of bonds. According to Bloomberg data, Putnam bond funds owned more than two-thirds of the outstanding bonds. Their total loss will be subject to the aquarium's bankruptcy case.

Second, many investors choose to purchase callable bonds. By nature, callable bonds generally provide relatively higher yields because they expose bondholders to greater uncertainty. They often possess incredibly attractive yields to a relatively short call date. However, they must also be examined to their final maturity, because if the bond is not called, investors bear the risk of holding a longer-term security. If investors are not also compensated to the final maturity, the bond could be a poor investment. Furthermore, as municipalities continue to refinance at lower interest rates, call provisions on new issues will become increasingly less likely to be exercised, leaving investors holding callable bonds to maturity.

A third method of increasing yield is purchasing bonds with longer maturities. This strategy has three perils. First, the price volatility of longer maturity bonds is higher, subjecting investors to more

interest rate risk. For example, when interest rates increased in 1994, the 30-year U.S. Treasury note fell 11.99%, as compared to the 4.26% decrease of the 5-year U.S. Treasury note. Second, in the current low interest rate environment, investors lock themselves into lower-yielding bonds for a longer period of time. Third, by purchasing such bonds, investors incur increased credit risk, as the fortunes of borrowers can change over time.

Yet perhaps an even greater peril than chasing yields is the structure of the municipal industry itself. The National Federation of Municipal Analysts concluded earlier this year that nearly 40% of municipal issuers provide inadequate disclosure. Yet according to Paul Maco, former director of the SEC Office of Municipal Securities, “the SEC can do little in terms of direct regulation.” The reason is that municipalities are not bound by the disclosure rules established by the Securities Act of 1933 and the Securities Exchange Act of 1934. Thus, municipal bond issuers are not required to file quarterly financial statements with the SEC, nor are they required to reveal information on their ability to make interest and principal payments.

The only true scrutiny of the municipal market rests on the shoulders of the Municipal Securities Rulemaking Board (MSRB), which is run by the dealers and issuers it oversees. Furthermore, it is organized in a fashion similar to the Financial Accounting Standards Board, which sets rules on accounting practices yet has no authority to police the auditors. This lack of oversight, plus the fact that municipal bonds do not trade on a central exchange leaves bond pricing largely at the discretion of the dealers that buy and sell bonds. In fact the MSRB only stipulates that the price should be “fair and reasonable”, an expression not quantified by the board.

In this environment, commission markups can run rampant. Kevin Olson, founder of MunicipalBonds.com, monitors the municipal market to identify high markup trades. He has found that sales markups of more than 4 points are not rare, and that they can even creep into double-digits. A markup of 4 points represents a 4% commission, or \$4,000 on a bond with a \$100,000 face value. Such a markup can cut the yield on a bond by more than 0.50%. The risk to an unwary bond investor is obvious.

So how can investors avoid the risks of the municipal bond market? Zemenick & Walker believes the primary goal of fixed income portfolios is the preservation of capital, with a lesser emphasis on yield. Thus, we avoid much of the risk in the market by focusing on high-quality bonds maturing in a 1-10 year ladder. Such portfolios consist of AA and AAA rated securities, including general obligations, Texas PSF's, pre-refunded and escrowed bonds, and bonds backed by state intercept programs or AAA-rated insurers. These insurers (Ambac, FGIC, FSA, or MBIA) step in during cases of default. The insurer assumes the responsibility of coupon payments and the overall bond obligation if the issuer is unable to fulfill its commitment. Furthermore, Zemenick & Walker's portfolio managers have established relationships with some of the most reputable brokers in the industry, insuring competitive pricing of all bonds purchased ■

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interest rates increase significantly, many individuals could be overwhelmed by the weight of their debt. A similar situation in the early 1990's helped to lead the economy into recession.

The Fed recently eased these fears for the short-term, dropping its benchmark overnight bank lending rate by one-half percent to 1.25%. Policymakers commented that the decrease should help solidify the recovery and characterized it as "an insurance against weakness". With inflation running at just over 2% and the Fed running out of room to cut interest rates much further, many people worry that the U.S. is at risk of experiencing general price deflation. However, Fed officials deny this is a significant risk and insist that tools other than short-term interest rates could be used to help avoid deflation.

Business investment spending is another essential component of a successful economic recovery and there is some hopeful news in this arena as well. After an estimated decline of 5.6% this

year, business investment spending is projected to increase by 3.6% next year. This would represent long-awaited relief for consumers, who have been supporting the economy single-handedly for a long time.

Equity markets have had a relatively strong fourth quarter through December 18th, with the S&P 500, a large cap stock index, up 9.74% and the Russell 2000, a small cap stock index, up 6.28%. Though there are forces that could derail this rally (see the article below), a mild market downturn would not necessarily have a detrimental impact on the economy. Nobel Prize winning economist Milton Friedman acknowledged this when he said, "People's attitude toward the broader economy [is] dominated by the stock market. There's a relationship [but] it's not a one-to-one, not even close."

While some potential economic stumbling blocks do exist, like rising unemployment and record-level consumer debt, the U.S. economy has already proven that it is capable of strong performance under difficult conditions ■

Corporate Pension Plans: Accounting's Perfect Storm

Over the past few years investors' ability to navigate the stock market has been challenged by successive waves of corporate scandals, bankruptcies, and accounting concerns. However, these issues may soon appear trivial compared to the next potential obstacle, underfunded pension plans. This problem was vividly described in a recent study by Credit Suisse First Boston.

According to the study, 360 companies from the S&P 500 either offer defined benefit plans or are obligated to pay retirees under legacy plans. During the bull market of the 1990's this liability was little more than an afterthought for most companies. After years of double-digit annual equity returns, the average pension plan was overfunded by 7% in 2000. However, in the past few years these gains were replaced by double-digit losses. As a result, the average pension plan was underfunded by 6% in 2001.

The situation continued to deteriorate in 2002 as interest rates fell to historically low levels, severely limiting the income produced by pensions' bond portfolios. Despite this, accounting rules allow companies to recognize gains on pension assets, which are calculated using an *expected* rate of return, as income. This artificially boosts net income. In fact, CSFB estimates that in 2001 S&P 500 companies booked \$104 billion of income on assets that actually incurred \$90 billion of losses.

Pension plans suffer from some of the same problems as social security. Higher life expectancies force pensions to pay benefits for longer periods of time. Moreover, as baby boomers retire, the worker-to-retiree ratio will drastically fall, forcing a relatively small group of workers to support a large group of retirees.

What does this mean to investors? Well, with a current combined shortfall of \$240 billion, many large companies are faced with a

tremendous burden. Once a pension plan is less than 90% funded, the payments needed to bring it to 100% may be required within three to five years instead of 30. As Janice Revell wrote in *Fortune* (Dec 3, 2002), "companies will have to start pumping cash -- some \$29 billion next year alone -- into pension funds. That's real money. Money that won't be going to dividends or research or new plants."

"In fact, CSFB estimates that in 2001 S&P 500 companies booked \$104 billion of income on assets that actually incurred \$90 billion of losses."

In order to mitigate the disruption to their cash flows of meeting pension obligations, companies may elect to fund up to 10% of their pension plans with their own stock, though doing this would have a dilutive effect on the shares of current stockholders and may not be a feasible option for a company like AMR, the parent company of American Airlines, whose pension plan is projected to be underfunded by more than \$3.3 billion by the end of 2002 and whose stock was trading at \$6.64 as of December 18th.

Additionally, the divergence of actual returns from expected returns has reached the critical point where many companies will be forced to start reflecting actual losses on their income statements, which CSFB says could reduce earnings by about \$15 billion in 2003. In a market focused on valuations, this may have a big impact on the stock prices of affected companies.

Having discussed the issue of underfunded pension plans with our equity managers, we are confident that they have given it adequate attention in constructing their portfolios. In addition, we believe diversified equity portfolios help to insulate clients from these types of market developments, as some sectors (in this case small cap) are not as heavily impacted as others ■

Our Mission

Zemenick & Walker is committed to providing superior investment advisory services to high net worth individuals, trusts, not-for-profit organizations, and retirement plans. As a fee-only, non-discretionary advisor, Zemenick & Walker eliminates potential conflicts of interest, giving clients a disciplined, business-like approach to the investment of their capital.

Avoiding Identity Theft

Identity theft has always been a cause for concern, but the proliferation of personal records on the Internet has made it more common. Listed below are some important steps that you can take to help protect yourself. Equifax.com provides a more complete list.

- Experts suggest checking credit reports on a regular basis.
- Make Internet purchases exclusively from secured sites.
- Memorize passwords instead of writing them down.
- Do not carry your social security card in a wallet or purse.
- Avoid the obvious when creating passwords, use both letters and numbers.
- Never leave receipts behind after making purchases.

Where to Get a Credit Report

Equifax

equifax.com P.O. Box 740241
800-685-1111 Atlanta, GA 30374

Experian

experian.com P.O. Box 9532
888-397-3742 Allen, TX 75013

TransUnion LLC

transunion.com P.O. Box 1000
800-888-4213 Chester, PA 19022

By the Numbers

<u>Interest Rates (Monthly Since 1970)</u>	<u>High</u>	<u>Date</u>	<u>Low</u>	<u>Date</u>	<u>Nov-02</u>
Federal Funds Rate	19.10%	June-81	1.34%	Nov-02	1.34%
Prime Bank Loan Rate	20.50%	Aug-81	4.35%	Nov-02	4.35%
3-Month T-Bill	16.30%	May-81	1.23%	Nov-02	1.23%
10-Year Treasury	15.32%	Sept-81	3.87%	Sept-02	4.05%
30-Year Mortgage	14.67%	July-84	6.07%	Nov-02	6.07%
<u>Stock Indices (Daily Since 2000)</u>	<u>High</u>	<u>Low</u>	<u>% from High</u>	<u>11/29/02</u>	<u>% from Low</u>
DJIA	11,723	7,286	(37.85%)	8,896	22.10%
S&P 500	1,527	777	(49.12%)	936	20.46%
NASDAQ	5,049	1,114	(77.94%)	1,479	32.76%
Wilshire 5000	14,752	7,343	(50.22%)	8,847	20.48%
EAFE	1,774	857	(51.69%)	986	15.05%

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