PEIRCE CAPITAL MANAGEMENT, LLC

Market Insights

December 22, 2010

A Response to the "60 Minutes" Segment on Municipal Finances

The following addresses the "60 Minutes" *segment from Sunday, December 19 on the state of municipal finances.*

The "60 Minutes" segment did not expose any new problems in the municipal market. Rather, it highlighted some growing concerns surrounding state fiscal problems and their potential effect on local governments. In fact, Meredith Whitney, who appeared in the segment on Sunday, released her views in a report back in September. Her report discussed the "day of reckoning" for municipals.

As we have noted in other client communications, state and municipality finances are generally in the worst shape they have been in save the Great Depression. We know this, and the market knows this. As a consequence, we do believe there is more risk in the municipal market than there was a few years ago.

Where we break with the views expressed by Whitney in the "60 Minutes" piece, however, is that we do not believe this will translate into widespread and systemic defaults across the municipal market. In our opinion, this ignores the protections afforded to general obligation and essential service revenue creditors and the willingness of states and municipalities to service their debt while cutting other expenditures.

We draw a distinction between the reality that state and municipal finances are in bad shape, which, as the piece noted, has clearly begun to force states and municipalities to cut expenditures and staff, and the likelihood that this will translate into markedly higher default rates. We think it is highly unlikely to go from a point of essentially no defaults historically on general obligation and essential services revenue bonds to default rates that are closer to those historically experienced by the high-yield corporate bond market. It is also worth noting that, at this point, almost all of the defaults since the financial crisis began have been in sectors of the municipal market that we do not buy (for example, industrial development, unrated assessment districts and healthcare).

Note, though, that we are not saying that the municipal bond market is free of default risk. The only fixed income securities that are free of this risk are U.S. Treasury bonds and FDIC-insured CDs. We do believe there will be more defaults in the future in the municipal bond market than there have been in the past, but we do not expect them to be as widespread as Whitney expects they will be.

With all this said, we continue to take the following steps with our clients' portfolios to limit default risk to the extent possible:

- Diversifying broadly across issuers and states
- Adhering to strict buying parameters in terms of sectors that we can buy
- Requiring that bonds within three years of maturity must have a credit rating of A or better and bonds with maturities of three years and out must have a credit rating of Aa or better
- Recommending that clients sell credits from some of the riskier issuers (for example, city of Chicago)
- Reviewing research by the general investment community and our broker-dealer community on issuers that we purchase and own

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In summary, we do believe there is heightened risk in the municipal market, but we also believe that municipal bonds are still of value for clients in relatively high federal tax brackets. We do not expect to see an astronomical increase in near-term defaults for general obligation and essential service revenue bonds. We also continue to review our existing positions to see if there are any we would recommend selling.

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