



FIRST WESTERN CAPITAL MANAGEMENT

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The State of our States and Municipalities

Municipal Bond Q & A

For a typically sleepy sector of the market, municipal bonds have captured more than their fair share of headlines of late. Following an extremely productive first ten months of the year, municipal bonds came under significant pressure in the two closing months as many took profits and abandoned the sector due to the perceived risks and uncertainty. A few prime time news stories, coupled with some recent defaults, have elevated concerns among many investors. Thus, we felt it important to address some of the current issues and answer questions facing many investors.

Q: Having watched the recent 60 Minutes episode with the interview of Meredith Whitney, are massive defaults imminent?

A: The aftermath of the Great Recession has severely impacted state and local budgets. Corporate America, having anticipated the difficulties to come, tightened its belt to weather the upcoming storm. Expense structures were reduced, including payrolls and business investment. In the public sector, however, changes cannot be quickly agreed upon or implemented. Only now are we seeing new leadership attempting to reduce headcount and seriously tackle budget issues. With the lone exception of Vermont, every state is required to reach a balanced budget on an annual basis. Although questionable tactics are often employed and delays do occur, states budgets are balanced. More importantly, though, state general obligation bonds carry the full faith and credit of the state. Thus, if a state's general fund was insufficient to support ongoing debt service, the state has unlimited ability to tax its public in order to meet its indebtedness. Therefore, one should not expect defaults at the state level. In fact, state tax receipts have increased by almost 4% over the past year.

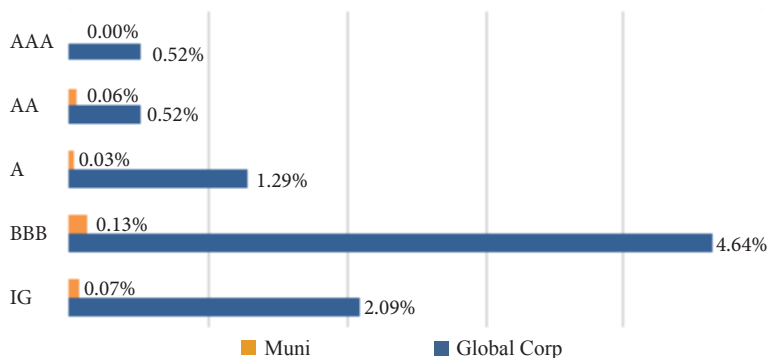
The budgetary difficulties are more pronounced at the local level. The absence of unlimited taxing ability for most local entities reduces their creditworthiness, but the main problem for these municipalities emanates from ongoing real estate woes. Since the primary revenue source for most municipalities is property taxes, problems may get worse over the next few

years as real estate turnover would likely lower future property tax revenues and further crimp local budgets. While this will pose serious challenges to local governments, the comment by Ms. Whitney suggesting "50-100 sizeable defaults worth hundreds of billions of dollars" is highly unlikely in our opinion. Importantly, the largest 100 municipalities do not even have hundreds of billions of debt outstanding. Therefore, to achieve her prediction, virtually all major municipalities would have to default on all of their debt. The assumption that all of the municipal bond rating agencies, bond dealers, and portfolio managers are not aware of this potential outcome - and have just "overlooked" this risk - is quite shortsighted. There are well-known risks and one should expect additional credit ratings downgrades for many municipalities. To be sure, there will be some local government defaults, but the quantity and magnitude will be nowhere near these headline levels.

Q: What type of bond defaults do you expect?

A: Historically, municipal bond defaults have originated from non-essential revenue bonds. Examples include sports arenas, health care, and real estate development ("dirt") bonds. Typically, these bonds rely upon revenues that will develop after the completion of the project. Of course, some of these projects are never completed, while others end up unable to generate sufficient revenue to service the debt. Defaults for general obligation bonds at the local level are rare, though occasionally do occur. Harrisburg, Pennsylvania, the state's capital, nearly defaulted in September due to an extremely expensive and poorly run incinerator project. At the last minute, the governor of Pennsylvania accelerated some state aid payments to prevent the default. However, this highly publicized episode, in the aftermath of the Chapter 9 bankruptcy filing by Vallejo, California, stoked the fears of many investors and has made for ample fodder by the financial media. One cannot expect future municipal financial difficulties to be bailed out by state funds, but bankruptcy filings should also be rare as approximately half of the states must approve local filings.

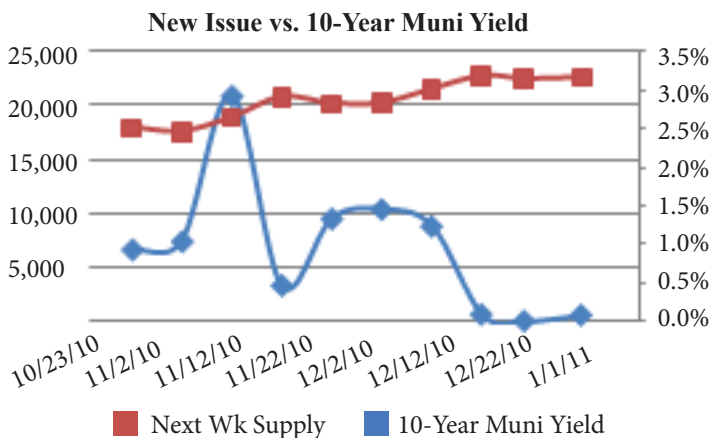
Moody's Default Rates



In addition, a default or bankruptcy filing does not mean an investor loses one's entire investment. Rather, defaulted bonds that are insured will likely fully recover their initial investment (assuming the insurance carrier remains healthy). In other cases, recoveries over the past forty years have been much higher for municipal bonds (60%) than for corporate bonds (37%).

Q: Why has the municipal bond market performed so poorly recently?

A: Recent market performance has turned quite ugly, resulting in the worst quarter for municipal bonds in the past 16 years. Several factors lined up to cause this dramatic selloff in the sector. First, the general level of interest rates, as measured by U.S. Treasury notes and bonds, became extremely overvalued. The expectation for an additional round of quantitative easing (massive bond purchases by the Federal Reserve) exacerbated the extreme overvaluation condition. The eventual announcement by the Federal Reserve in early November sparked a massive correction in price and increase in rates. This classic case of “buy the rumor and sell the news” pushed municipal bond prices down considerably. Exacerbating the selloff was the uncertainty around the highly successful Build America Bond (BAB) program. A federal government interest subsidy of 35% instigated heavy taxable municipal bond issuance, especially in maturities beyond 10 years. Fearing that the BABs program may not be renewed for 2011, issuers rushed to market in November and December. This supply overwhelmed demand, further pressuring prices. As it became evident that the BABs were not included in the tax bill, further damage ensued in the tax-exempt market. As all this occurred, individual investors were redeeming their municipal bond mutual fund shares at an alarming pace. To find a clearing price for all of the current and anticipated municipal bond supply, prices had to drop considerably.



Q: What is the appropriate municipal bond strategy in this complex environment?

A: Separating the facts from the sensational headlines is half the battle. Many investors have let fear overtake rational thought and will therefore miss good relative value opportunities within the tax-exempt space. Some strategists have recommended a focus of very high-quality bonds with very short maturities. With the dislocation in the market, the approach adopted at First Western Capital Management is to capture much of the excess

yield premium available without accepting much additional risk. Several months ago, with interest rates at historic lows and municipal bonds at less attractive valuations, we felt it timely and appropriate to reduce portfolio risks for all of our clients. We sold intermediate and longer maturity bonds and took profits from positions in higher risk states. For example, most of our national tax-exempt clients had purchased California general obligation bonds at a 2% yield premium to AAA-rated averages. As sentiment improved and the yield advantage narrowed to only 1%, we felt it time to take profits as we wished to be compensated more than the market was currently paying. Importantly, much of our overall decision to reduce portfolio risk was driven by our expectation for significant supply imbalances in the latter part of the year. A deluge of new bond issuance, reduced demand, uncertainty surrounding the Build America Bonds program, and extended valuations were a recipe for a very difficult municipal bond market. Thus, we built a sizeable position in cash and cash equivalents (Federal Agency notes of 2 years or shorter) as we waited for our thesis to unfold.

Tax-exempt bonds struggled mightily in November and December, so we have started to reinvest some of the cash at these much improved valuations. However, rather than paying high relative prices for very short-term, top-quality bonds, we believe one can vastly improve the risk-return tradeoff in this environment. We prefer the strategy of finding the best quality bonds in several of the troubled states. These bonds are typically very well-structured revenue bonds that are not reliant upon the health of the state or local finances. For these opportunities, we favor the shorter maturity issues and have realized additional yield (to comparable quality issues in higher rated states) of between 50 basis points (1/2%) to 75 basis points (3/4%) simply due to the market’s negative perception of the state. For example, the well-noted troubles facing Illinois, stemming in large part from its huge unfunded pension liability, has made the Prairie State the cheapest in the country. Instead of purchasing bonds directly tied to the state’s general finances, we prefer the 3 ½ year notes issued by the Regional Transportation Authority (RTA). These AA-rated bonds have a tremendous amount of credit support, derived from bus and subway fare revenue from throughout the state. While these bonds are obligations of the RTA, they also enjoy an additional layer of support from the state fund and carry insurance from AGM, one of the few remaining highly-rated municipal bond insurance underwriters. With these types of bonds filling our shorter maturity needs, we have favored highly liquid bonds from the top-rated states in the 6 to 8 year maturity range.

This combination of quality bonds from various states gives us a relatively short duration portfolio with an average AA rating and a yield advantage to most comparable strategies.

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