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Innocents Abroad

By Mike Davis, CFA, CIC

Our eighteen year old daughter, Jenny, approached my wife and me the other day with the radical proposal that she and a friend be allowed to travel by themselves in Europe for a month this summer. My immediate reaction was, "Gee, honey, why not just travel in the United States, instead?" This elicited from Jenny the predictable, "Oh, Dad!" response, and we are still at loggerheads on this issue.

Perhaps you are wondering what our little family drama has to do with investing? Well, it reminded me that Clifford Swan has, for some time, been exploring ways to invest outside our borders. There is no denying that Switzerland is like the Grand Tetons on steroids (and you get cheese thrown in, to boot), the major European capitals are, for the most part, more beautiful than our major cities, and the beer is better in Prague than in Milwaukee (don't tell my daughter that). So, isn't it also worth examining if there are interesting and rewarding investment opportunities overseas? We believe the answer is yes.

Experience tells us the U.S. economy is relatively mature and

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Choppy Waters:
Navigating the Municipal Bond Markets

By Lloyd Wong, CFA

Traditionally, the $2.9 trillion municipal bond market has been a safe haven for those seeking income that is protected from taxes. Two-thirds of municipal bonds are held by individuals, either directly or through mutual funds. These individuals are seeking to invest in them primarily for their tax-free income and secondarily for their yield. However, the generally tranquil municipal market has been experiencing more ups and downs than usual in the past few months, leading investors to exit municipal bond funds in droves and question their viability as a safe haven.

Numerous events, ensuing from the financial crisis, have contributed to the municipal market's recent downturn. Our last newsletter article addressing municipal bonds (reference "The Municipal Bond Earthquake: Security in an Insecure World," *Clifford Swan The Investment Counselor*, First Quarter 2009) alluded to the downgrading of municipal bond insurers subsequent to the subprime mortgage debacle of 2008 and the exiting of insurers from the municipal bond market. Today, only 7% of newly issued bonds carry insurance compared with 57% in 2005. Previously, bond insurance had a homogenizing effect on municipals; as a consequence, the removal of bond insurance has resulted in a more fragmented bond market where higher-quality bonds trade noticeably more expensively than lower-quality bonds. In April 2010, Moody's decided to recalibrate municipal bond credit ratings to be more comparable with other types of bonds. After the recalibration, the percentage of AA municipal bonds increased from 53% to 82%, creating a form of ratings inflation and making it even more difficult to differentiate bonds based solely on ratings.

Another consequence of the financial crisis is the reduced number of bond dealers (Bear Stearns and Lehman Brothers were major municipal bond dealers before their collapses), resulting in less market liquidity and a more thinly-traded market evidenced by the drop in daily trading volume to one-third of that traded four years ago. Since banks and brokers are less willing to hold large municipal inventories, the time it takes to execute a trade and the price at which it is executed has been impacted. As a result, there is now more price volatility in the municipal bond market.

In response to the financial crisis, President Obama introduced the American Recovery and Reinvestment Act (ARRA), which created the Build America Bonds (BABS) program. The BABS program, initiated in April 2009, allowed municipal issuers to sell taxable debt and collect a direct 35% subsidy from the Treasury Department in lieu of the previous indirect subsidy of tax exemption. While the program opened

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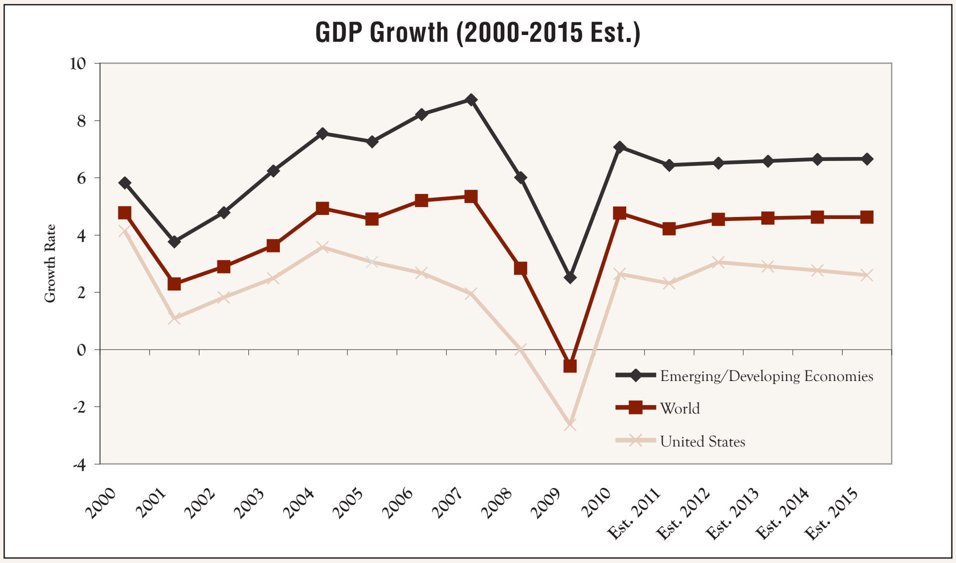
not expected to grow as rapidly as many foreign economies. The graphic below provides dramatic visual evidence of this.



SOURCE: WORLD ECONOMIC OUTLOOK DATABASE, INTERNATIONAL MONETARY FUND

By tapping into this growth through investing in good businesses which are prospering overseas, we may be able to enhance the investment return produced for our clients. In addition, we may be able to reduce overall portfolio risk by diversifying client assets more effectively across a broader spectrum of companies and markets. Financial theory also tells us that we should be able to achieve additional reductions in portfolio risk because stock price movements in foreign markets normally do not occur in lock-step with U.S. stock prices. Academics refer to this as low correlation. Practically, it means when one market is going up, another is likely going down. If both markets are expanding over the long term, the counterbalancing near-term movements tend to smooth out the portfolio return, also referred to as lowering volatility. In addition, the U.S. dollar may be at risk of a continuing devaluation because of our need to borrow from foreign entities to finance our budget deficit, and because of our declining influence in the world. Investing overseas can be a simple, effective strategy to hedge against devaluation, if one's investments are made in countries whose currencies are appreciating against the dollar.

So far, this international investing sounds pretty compelling, right? Well, no surprise, there is a dark side to investing overseas which arises from the very differences which also provide the potential investment benefits discussed earlier—they are foreign. It is analogous to going to see a foreign film, and coming out befuddled, asking, "Why do foreign films have to be so foreign?" A similar comment could be made by investors when they try to understand foreign economies, markets, and companies. At the macro level, there are cultural differences; economic risks, such as those which may arise from the more socialist systems that we encounter in Europe; or even state-run economies such as China. To that, add political risk from less democratic regimes and their potential for overthrow, such as we now see in North Africa. At the micro level, we often encounter balance sheet and income statements for foreign companies which are less analyzable because of different accounting methods and less transparency. Finally, many stock markets overseas are relatively new and untested. They may also lack the liquidity to enable efficient trading, especially during times of financial panic such as we experienced during the worldwide bear market of 2008/2009.

Before you get discouraged by the risks outlined above, let me assure you there are ways to invest overseas with a positive tradeoff between return and risk. One of the best ways to gain international exposure is by investing in U.S. companies which derive a large part of their earnings and growth from either exporting goods, or manufacturing goods (also services) in foreign countries. The table, below, provides a small, representative sample of U.S. companies employing this strategy effectively.

Company Name	Foreign Revenues as a % of Total
Colgate-Palmolive	78%
Exxon Mobil	70%
General Electric	54%
Intel	80%
Int'l Business Mach	64%
Johnson & Johnson	50%
Microsoft	42%

The advantage of this investment strategy is clear: it eliminates much of the "foreignness" because of investment with U.S. managers who are using tried and true methods we understand. Many U.S. companies have a long record of success in tapping into growing economies and markets overseas.

Still, there are limited benefits to this approach. First, it constrains our choice of companies to those that are U.S. based. What if Unilever, based in the U.K., is a better run, faster growing, more profitable business than Procter & Gamble? Other examples might be Siemens (Germany) versus G.E., Hong Kong Shanghai Bancorp versus J.P. Morgan, or Toyota versus Ford.

Another drawback of sticking to U.S. companies is that it doesn't allow the investor to profit from exposure to foreign stock markets, which may be ripe for appreciation because they are periodically undervalued versus the U.S. stock market.

These disadvantages may be overcome by investing in pooled vehicles such as mutual funds, country funds, and index funds, which invest in foreign companies. The latter two offer a passive (non-managed) and relatively inexpensive way to obtain exposure to an investment theme such as the ongoing integration of East and West Germany (The Germany Fund) or growth in Asia (The Vanguard Pacific Stock Index Fund). Mutual funds offer a way to participate in a theme while targeting specific companies which the managers believe will perform better than a broad index of companies. The investor pays higher fees to compensate the managers for the research effort involved in selecting individual stocks for investment. In exchange, the investor expects a superior return to compensate for the additional cost. Mutual funds generally employ analysts who either live in those countries or spend considerable time there and speak the local language. In this way, they overcome the "foreignness" which puts us at a disadvantage.

When we decide to invest overseas, we must not only determine with whom to invest, but also where to invest and in what types of companies. We have the choice between relatively developed and mature markets, such as Europe, the U.K., Japan and Australia, or developing or emerging markets in countries such as China, India, Korea, and Brazil. The developed markets will be slower growing, more stable, and more correlated to the United States because of the close trade interface between the regions. The returns should be commensurately closer to those available in the U.S.. The developing world offers more growth potential and the prospect of higher returns, but at the risk of more volatility because of political instability and less liquidity. The mix between developed and developing exposure can be tailored to meet the investor's demand for return and tolerance for risk.

Regarding types of companies, the major choice is between large capitalization and mid-to-smaller caps. An example of a strategy here would be, if we want to invest in China's growing exports to the rest of the world, we need to purchase stocks in bigger companies which have the capacity to meet large global demands. In contrast, if our theme is to participate in the growth of China's local economy, mid- to small-sized companies probably afford a more targeted play.

Our trip to explore the international landscape is coming to an end. We hope you have returned with a better understanding of the opportunities available overseas. My daughter will discover, if she goes on her trip, that sizeable risks are encountered when one crosses our borders, but that there is also the possibility of great rewards. The same holds true in investing. We look forward to being your tour guide. ◆

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up the municipal market to new buyers, such as pensions and endowments, and increased the supply of bonds available to both tax-exempt and non-tax-exempt buyers, it also reduced the supply of tax-free bonds coming to market. Total municipal issuance in 2010 was $430 billion, with taxable BABS comprising 20%. Additionally, ARRA made private-activity bond interest exempt from the alternative minimum tax (AMT), freeing-up access to the tax-exempt bond market for airports and seaports, both of which have benefited from lower rates. When it became clear that these programs would not be extended, but instead were set to expire in December 2010, there was a rush by issuers to issue debt ahead of the deadline, causing the market to be inundated with considerable supply at year end.

The Federal Reserve's stimulus programs introduced subsequent to the financial crisis left interest rates lower across the board. Investors seeking yield in traditional money markets were forced to look elsewhere. Between January 2009 and November 2010, there were 22 straight months of inflows into municipal bond funds summing to $101.3 billion, fostering a bond bubble of sorts.

Meanwhile, the economy has slogged along with unemployment stuck stubbornly high at 9% or above. State and local governments continue to struggle with lower tax revenues. The fiscal stress has taken its toll on a number of states including the State of California, which had its debt downgraded to A in February 2009 and again to A- in January 2010 by Standard & Poor's. The city of Vallejo, CA declared bankruptcy in 2008, and in 2010, the city of Harrisburg, PA was unable to service its debt and required an 11th hour bailout by the state. News headlines continue to be peppered with stories of increasing budget gaps for state and local governments, particularly with respect to unfunded pensions. Recent commentaries have addressed the possibility of states declaring bankruptcy as a means by which to restructure union contracts that currently dictate future long-term pensions, health care benefits and other post-employment liabilities. Currently, the states are split about 50/50 on whether they are eligible to authorize Chapter 9 bankruptcy, and Congressional hearings are expected on the subject in the next few weeks. Also, with the expiration of the BABS program and its 35% subsidy, the roll-off of Federal Reserve stimulus money has meant that state and local governments may need to go it alone in the future, with higher borrowing rates and fewer bond buyers in the traditional tax-exempt market. Needless to say, numerous negative headlines have stoked fear in municipal bond investors' minds.

At the beginning of November 2010, the Federal Reserve announced a second round of quantitative easing, which had the unexpected effect of increasing, rather than lowering, rates for longer-term Treasuries, resulting in lower prices for municipal bonds. Then, in mid-December, bank analyst Meredith Whitney made her dire prediction on "60 Minutes" that there would be as many as 100 municipal defaults totaling hundreds of billions of dollars, a prediction which Whitney has been unable to substantiate and which many analysts have considered overblown. Unfortunately, the damage was done. A combination of increased supply from BABS issuers, eager to issue debt before the December 2010 expiration, and the dramatically decreased demand from nervous investors faced with declining municipal bond prices and pelted with negative press, created an environment of panic. Since November 2010, there have been record outflows from municipal bond funds of more than $36 billion. Increased redemptions have forced municipal bond fund managers to sell bonds in order to raise liquidity for investors withdrawing funds, leading to the selling of bonds at, perhaps, inopportune times. This put more short-term downward pressure on prices. And,

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most tellingly, iShares S&P National Municipal Bond ETF (MUB), a proxy for the municipal bond market, dropped a dramatic 8.6% between November 5, 2010 and January 14, 2011.

Despite all this gloominess, there have been some recent positive developments in the municipal bond environment. At the end of January 2011, Moody's announced that it will start including pension obligations when evaluating state credits, in order to enhance comparability. Additionally, states and local governments are required to balance their budgets, and there is evidence that some states are trying to do the right thing for bondholders by taking painful, but fiscally responsible, action. The State of Illinois raised its income taxes by 67% from 3% to 5%. The State of Texas cut 8,000 jobs and cut spending by 11%. The governor of California announced $12.5 billion in proposed spending cuts. There have even been positive lessons from Vallejo's bankruptcy; the city mayor was quoted as saying, "We ought to stop living on credit and find ways to offer the same level of service for less money." Additionally, there are signs that the economy has started to strengthen, as preliminary tax revenue data for the 4th quarter of 2010 shows an increase in state, income and sales tax collections.

Just because news headlines tout the deterioration of credit quality for certain issuers doesn't mean that the credit quality for *all* issuers has deteriorated. Understandably, the misdeeds in some segments of the public sector have undermined the confidence of investors, but the recent panic-driven selling has resulted in yield increases which can present some interesting buying opportunities. In fact, bond guru Bill Gross of PIMCO is a current buyer, having invested his own money in five of his firm's municipal bond funds recently. That being said, the municipal bond market shows signs of stabilizing as prices have firmed up. And, as of this writing, MUB has recovered half of its 8.6% loss since January 14, 2011.

In general, municipal bonds continue to be an important asset class for diversified taxable portfolios. Municipals provide tax-free income which seems critical in an environment that sees growing Federal budget deficits ($1.6 trillion at last count). Furthermore, municipal bonds, as a whole, are safe. For instance, the municipal bond default rate is historically low relative to corporate bonds. Between 1970 and 2009 Moody's reported only 54 defaults out of thousands of rated municipal issuers. In 2010, there were only 5 bankruptcy filings totaling $4.25 billion, or 0.21% of the market. However, the municipal bond asset class itself represents a wide spectrum of risk. Proper due diligence and selectivity are paramount to buying bonds that are appropriate for your risk level.

Clifford Swan's strategy on municipal bonds involves comprehensive credit analyses including reviews of issuers' Official Statements, most recent Comprehensive Annual Financial Reports, issuers' websites and local news articles. Since bond insurers' ratings are now all but meaningless, we evaluate an issuer's credit quality by reviewing cash flows, reserves, pension obligation status, ability to pay debt, significance of underlying project(s), type(s) of security backing involved and economic/geographic area. We avoid areas with decreasing populations, increasing unemployment, high pension liabilities and increasing deficits. We seek to lower risk by purchasing pre-refunded bonds (which have collateral, such as U.S. government securities, set aside to pay off the bonds by a certain pre-refunded date) and essential service revenue bonds (backed by an essential service revenue stream, such as water or sewer). We avoid higher risk by limiting exposure to lower quality K-12 school districts and redevelopment agencies. We do not buy bonds for which there is no information or disclosure. We seek to minimize overall risk by diversifying across geographic areas, bond type and revenue type. Additionally, with interest rates at historical lows, we are focused on short- to intermediate-term maturities in anticipation of rising rates in the future.

Undoubtedly, the municipal bond environment has become more tumultuous in recent years, with a more fragmented and volatile market that is extra-sensitive to negative headlines. However, Clifford Swan's consistent research and comprehensive credit analysis will continue to provide our clients with the selectivity required to navigate their portfolios through both choppy and calm waters. ◆

SOURCES: *BOND BUYER*, MOODY'S, BARCLAY'S CAPITAL, INVESTMENT COMPANY INSTITUTE, *WALL STREET JOURNAL*

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