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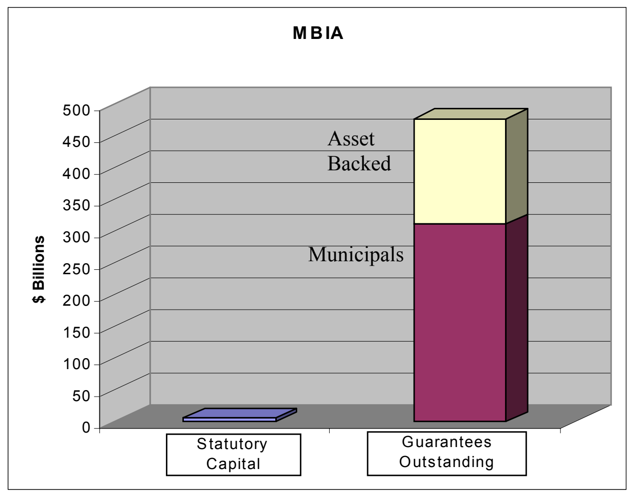
Not All AAA Bonds Are The Same

The Wall Street Journal in its November 5 "Heard on the Street" column reported that some large institutional investors are betting on problems at the municipal market's largest insurer, MBIA Corp. As a result, the cost of hedging exposure to MBIA in the credit-default swaps market has risen significantly. In fact, it now costs as much to hedge AAA rated MBIA as it does BBB rated Marriott International Inc. Since the credit-default market has done a pretty good job of predicting past credit problems, we think its treatment of MBIA is noteworthy.

Why the sudden concern about MBIA? The Wall Street Journal article suggests either corporate bond exposure or off balance sheet liabilities. A better answer may be the growth in the company's business in asset backed securities. Today, MBIA's primary business is no longer municipal bonds. Asset-backed bonds secured by pools of credit card debt, auto loans, home equity loans, etc., account for over half the company's earned premiums in the first half of this year. On the adjacent chart we show the significance in MBIA's asset backed business. Outstanding guarantees for asset backed issues are now $166 billion compared with $311 billion for municipals. We also show MBIA's statutory capital of $5.163 billion for reference.

It's ironic that in the same issue of the Wall Street Journal, right above the column about MBIA was an article about a default in the asset-backed securities market entitled: "A Jolt for the Asset-Backed Bond Market". MBIA has no exposure to the issue in default, but those that do own this once AAA rated bond, including high-grade funds such as PIMCO, seem to have been completely blind-sided. As the article points out, this is a very new and fast growing market. Its resiliency in difficult economic times is untested. How then can we really judge whether MBIA has sufficient capital to cover its potential losses in asset backed securities? Clearly some institutions have their doubts.

The municipal market has always treated bond insurance with a certain degree of skepticism. Bonds rated AAA because of insurance have never traded like natural AAA bonds. In fact, it is often the case that AAA rated insured hospital bonds can be purchased at a significantly higher yields than comparable A or even BBB rated general obligation bonds. Institutional investors look through the rating and insurance, recognizing that security ultimately comes from the strength of the underlying obligation. At Breckinridge, we only buy bonds that stand on their own merit not relying on credit enhancement from MBIA or any other insurer. In today's uncertain economic climate, we believe such a prudent approach makes more sense than ever.



Looking Ahead

Low inflation, a soft economy, an accommodating Fed and nervous investors have all combined to keep interest rates low. They are likely to stay low or go lower until one or more of these circumstances change. The market remains torn by two very divergent views. One sees the US economy as threatened by global deflationary pressures while the other worries that a weaker dollar and excessively stimulative monetary and fiscal policy will re-ignite inflation. Breckinridge continues to hedge both risks by structuring portfolios with a blend of short and long intermediate maturities. Doing so, we believe, achieves the best balance between stability of principal and sustainability of income.