

December 2004

Municipal bonds rallied through December, recovering much of the loss in value from November. The five year area of the curve rallied back to the levels from the end of September at 2.68% (vs. 2.66% 9/30/04). The rally was somewhat unusual in that the Fed Funds rate rose to 2.25% while yields on one-year municipals actually ended the month lower.

For much of 2004, we maintained a maturity barbell and were short of our benchmark durations. The barbell strategy worked quite well as the yield curve was significantly flatter by the end of the year. The spread between one and ten year yields closed from 229 b.p. to 152 b.p. The 10-year bonds added a strong income flow with relatively little price volatility. However, we were short of the benchmarks for most of the year which cost us some yield. The price decline of short assets was very small but the bonds did not throw off enough income to compensate for the relatively slow rise in rates.

We continue to believe a cautious stance on interest rates is warranted in 2005 since we anticipate volatility coming from the reversal of the 2004 oil shock and diminished international demand. The minutes of the FOMC meeting from December point to more inflation risk stemming from a stronger employment market. The Fed has indicated that the Fed Funds rate will continue to rise to fight inflation. We are maintaining the barbell strategy through the Fed tightening in expectation of a flatter yield curve.

Municipal Bond Insurance

2004 set a record in that 54.9% of new issue bonds were insured. Almost 90% of the insured bonds have insurance from one of four companies: MBIA, FGIC, AMBAC or FSA. The competition between these companies has lowered the cost of insurance over the last few years. The growing supply of insured bonds raises the question of the value of the coverage. The other issue raised is the accuracy of the AAA rating on the bonds that are insured.

As an overview, the four major municipal bonds insurers are all AAA-rated bond insurers. One of the primary concerns for these companies is maintaining their AAA-rating on their insured bonds. Recently, Gotham Partners Management Co., LLC, issued an analysis of the largest municipal bond insurer, *Is MBIA Triple A?*, questioning their AAA-rating. They concluded that MBIA would go into a downward spiral if they lost their AAA-rating. According to MBIA CFO Neil G. Budnick,

quoted in the report, “MBIA would be at risk of a downgrade in the event it were to incur losses approximating \$900 million to \$1.7 billion.” This loss would represent only 0.16% to 0.31% of the total Net Par Outstanding reported by MBIA Insurance Company in their Third Quarter 2004 Investor Presentation.

The concern is heightened by insurance companies expanding beyond municipal issuers into the other lines of business, a trend we first commented on in our November 2002 newsletter. Each company uses a different figure to break down the exposure to different markets. The table below uses the percent break down for either par value or revenue for the companies:

Company	US Municipal	US Structured Finance	Non-US Exposure
MBIA ¹	46%	21%	33%
FSA ²	58%	42%	0%
AMBAC ³	52%	30%	18%
FGIC ⁴	87%	13%	0%

¹ MBIA Third Quarter Investor Presentation, by Revenue

² FSA Corporate Website, Insured Portfolio Diversification.

³ AMBAC Fixed Income Presentation, Diversified Guarantee Portfolio.

⁴ FGIC Fixed Income Presentation, Insured Portfolio.

These concerns explain why AAA-rated Insured bonds trade at a higher yields than many lower rated uninsured issues. This implies that the market “looks through” insurance and pays greater attention to underlying credits. Given the insurers’ aggressive moves into other businesses, we continue to think this is very appropriate and therefore, look for credits that meet our high quality standard without insurance before we invest.

Spread to AAA-Rated Bonds

