

## BOND INSURANCE REVISITED

The opening paragraph in our November 2002 market commentary titled "Not All AAA Bonds Are The Same" could have been written this November.

*"The Wall Street Journal in its November 5 [2002] 'Heard on the Street' column reported that some large institutional investors are betting on problems at the municipal market's largest insurer, MBIA Corp. ... 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."*

*(Breckinridge November 2002 Newsletter)*

MBIA's (and the other insurers, AMBAC, FGIC, CFIG, ACA, Radian and SCA) diversification into insuring other asset classes such as Asset Backed securities and Collateralized Debt Obligations (CDO's) has resulted in an enormous cost. The companies' profitability and possibly their ability to efficiently function as an insurer has been called into question as losses on securitized sub-prime mortgage structures mount.

The concerns relate to the fragile status of some of the insurers' credit ratings. With the increasing number of defaults in sub-prime mortgage backed securities, insurers' capital reserves have been reduced. Current levels may not provide enough claims paying resources to qualify for their AAA ratings. Fitch and Moody's are now evaluating how the increase in defaulted securities affects the companies' capital levels, and the subsequent impact on their credit ratings. According to a Bloomberg November 21, 2007 report, ACA is rumored to be the first to be downgraded and ACA has a large exposure to municipal bonds. (Breckinridge does not hold any bonds that are insured by ACA.) Investor fears of a credit rating downgrade to below AAA are mounting in the municipal bond market as the ramifications are more fully understood.

## SOME HISTORICAL PERSPECTIVE

Over the past several years many investors may have become complacent about buying bonds with the AAA rating from one of the bond insurers. We believe that in some cases not enough attention was paid to the even more important underlying rating. A rating downgrade of an insurer would negatively affect billions of bonds especially those with weak underlying fundamentals.

However, with roughly 55% of municipal bonds currently issued carrying insurance, and billions of insured bonds outstanding it is nearly impossible to avoid buying insured municipals; and in our opinion, unnecessary. There are countless opportunities to buy high grade municipals at attractive prices in both the primary and secondary markets that happen to have insurance. In fact in a commentary on Bloomberg November 6, 2007 Joe Mysak noted:

"James Grant, editor of 'Grant's Interest Rate Observer' questioned in the Nov. 1 issue,

*'the proposition that an uninsured, double-A rated American state or municipality is, or ever was, in need of the triple-A imprimatur of a supremely leveraged bond insurer.'* He went on to predict *'a new bull market in credit analysis in the perennially over insured, and under-analyzed, realm of municipal finance.'* "

The markets are already starting to differentiate between credits based on their underlying rating, rather than the bond insurance. We believe these distinctions are valid and may become more pronounced as more investors focus on the stand-alone fiscal strength of a municipality.

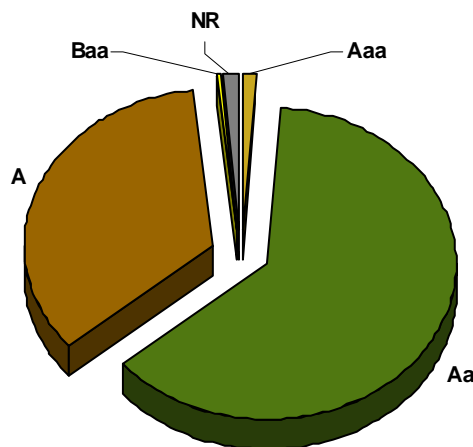
## BRECKINRIDGE'S PHILOSOPHY

### *CONSISTENT IN OUR PROCESS*

Breckinridge has consistently stressed the importance of reviewing the underlying credit quality of a municipal bond (excluding the bond insurance). We reiterated this stance in our commentary dated [December 2004](#). Potential purchases are subject to review by our Credit Analysts and, if purchased, are assigned an internal rating that takes into account issuer characteristics and fundamentals independent of bond insurance. Consequently an insured bond often does not meet our quality requirements even though it carries a AAA rating from one or more of the nationally recognized rating agencies.

In our opinion a better use of the rating agencies analysis is to monitor the ratings of an issue absent of any credit enhancement. The chart below illustrates these "underlying" Moody's, S&P or Fitch credit ratings of insured holdings in the intermediate municipal composite.

***Underlying External Rating Profile for AAA Rated Insured Bonds***



Source: Moody's, S&P, Fitch

## OPPORTUNITIES

As is typical during times of market stress, often the "baby is thrown out with the bathwater", and high quality bonds end up being mispriced. We are monitoring this type of situation carefully and will be alert to any opportunities that may arise.