"To be or not to be AAA rated " or "A rose by any other name is but a..."

Ronald P. Bernardi, President

With the start of another school year well underway, we turn our attention to Shakespeare and statistics and discuss the two subjects as they relate to credit analysis in the municipal bond marketplace.

All too often in our day to day wanderings through the municipal bond marketplace, we are continuously surprised to find the general attitude among certain investors that all bonds are really the same and that certainly all "AAA" rated issues are equal. The belief that an insurance policy on a bond issue somehow creates a "municipal bond commodity" that should be valued uniformly much in the way that we value other commodities is wrong. Yet this belief pervades our marketplace and from our perspective creates outstanding opportunities for the knowledgeable investor and portfolio manager; opportunities that we and our portfolio management clients take advantage of each and every day. Our purpose today is to share with you some of our insights on this topic.

The data shown in the table on page 3 provides a good snapshot of each of the three credits and represents some of the information that we study when assessing whether or not a credit is suitable for a particular portfolio.

Clearly, Issuer #1 offers the most substantial credit quality and justifiably deserves it's coveted "AAA" rating. Issuer #2 is solid as well, although certain categories suggest a trend toward heavy reliance on debt. This credit is a weak "A" rated credit, but the issue received the "AAA" by paying a premium and purchasing an insurance policy covering principal and interest payments. Issuer #3 is the smallest of the three and qualified as a Bernardi A* given real strength in a number of the categories.

This next table shows actual yields for various maturities of our three issues. It is important to know that all three issues came to market on the same day:

	#1 AAA Non-Insured	#2 AAA Insured A2 Underlying	#3 Non-Rated Bernardi A*
Years	**Yield**	**Yield**	**Yields**
2005	4.58%	4.61%	4.90%
2010	4.88%.	4.952%	5.15%
2020	5.58%	5.50%	5.90%

Compare how little yield differential there is between the 2005 maturity for Issuer #2 versus Issuer #1 (three basis points). After reviewing the much stronger financial picture of Issuer #1, the "extra" yield is not nearly enough reason to invest in that bond versus the 4.58% offered by Issuer #1. In our opinion, even the 2010 maturity does not offer enough of a yield bonus. The 2020 maturity actually offers a **lower** yield! These two "AAA" rated issues are clearly not the same from a credit standpoint and yet the market has priced them that way. Good for Issuer #2, bad for the investors that dearly overpaid to buy that "AAA" rated bond.

Issuer #3 has had to pay the highest interest rates of the three. The credit is solid, though it clearly lacks the resources of Issuer #1. In a number of categories it offers better credit numbers than Issuer #2 and is attractively priced given the significant yield pickup across all maturities offered by Issuer #3 compared to the other two. The 5 and 20 year maturities in particular offer yield spreads in excess of historical norms. Given the solid credit standing and both the absolute and relative yield differentials, we believe Issuer #3 offers excellent value and should have a place in most managed portfolios. Issuer #1 is clearly a good value within the "AAA" realm and is appropriate for certain portfolios. Issuer #2 is plain and simply way over priced. It is not a good value for our managed accounts.

I mentioned earlier that all three issues came to market on the same day. What I didn't mention was that only one of these issues sold out immediately... Issue #3.

"To be or not to be AAA rated?" William Shakespeare shouldn't be the only one asking that question.

The table below compares financial data for three different municipal issuers. All three issuers recently came to market with competitively bid General Obligation issues:

	#1 AAA-Non Insured	#2 AAA Insured	#3 Non Rated Bernardi A* Qualification
Assess Valuation	$3,120,000,000	$290,700,000	$112,380,000
Direct Debt	$20,000,000	$1,685,000	$2,950,000
Direct Debt/Capita	$285	$120	$695
Direct/ Overlapping Debt	$313,000,000 (6.9% of EAV)	$45,000,000 (15.5% of EAV)	$11,942,000 (10.6 of EAV)
Total Debt/Capita	$4,400	$3,200	$2,835
Population	70,200	6,100	3,514
Largest Tax Payer	0.032%	1%	1.84%
Top 10 Tax Payers	11%	4.5%	12.25%
General Fund Balance	$29,000,000 (51% of total revenues)	$1,500,000 (30% of total revenues)	$920,000 (20% of total revenues)
Tax Collections	99.75%	99.8%	99.85%