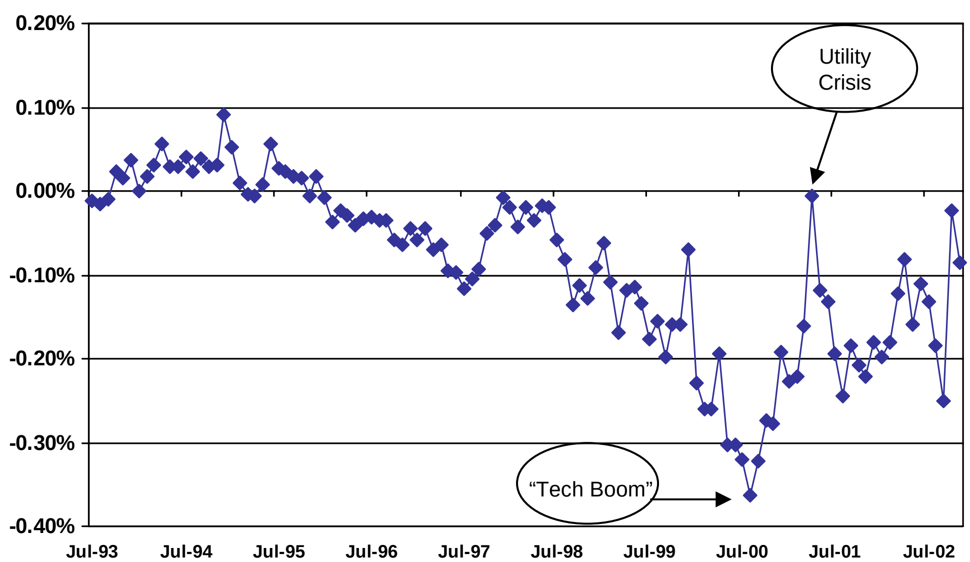
Fixed Income Insight
January 2, 2003
Are California Bonds Poised to Underperform?

Since the utility crisis in 2001, California's budget deficit has ballooned. Meanwhile extreme shortages and excesses of bonds have caused the yield to investors to fluctuate wildly, relative to the yields available out of state. Despite California's high local income tax rate, most investors could have realized higher income and after-tax returns from a diversified portfolio that included out of state bonds.

History of California Yields

As a proxy for the yields and returns on a state specific portfolio and national diversified portfolio we compared the Lehman Intermediate California Municipal Bond Mutual Fund index to the Lehman 7-year municipal bond index. We chose these indices because they have very similar durations or interest rate sensitivity. The attached chart 1 shows the yield levels on the California index compared to the nationally diversified index. At the lows of the 1990 recession, when California was last rated A1, yields on the California index were as much as 10 basis points more than the national index portfolio. The peak occurred during the Orange County financial crisis. From 1995 on, strong demand driven by the technology boom have caused relative yields to decline to nearly 40 basis points below national yield levels.

California Yield Less National Yield
7/31/93 - 11/30/02



Source: Lehman Brothers

In 2001 the utility crisis prompted a state downgrade and expectations of $12 billion of increased supply. Due to legislative stalemate and potential court actions the supply failed to materialize. Consequently, low supply caused yields to decline to levels below those recorded prior to the utility crisis. Supply finally materialized and yields rose. Compared to how they would have fared by investing in comparable out-of-state bonds, investors in California bonds incurred dramatic underperformance.

Guiding Portfolio Strategies

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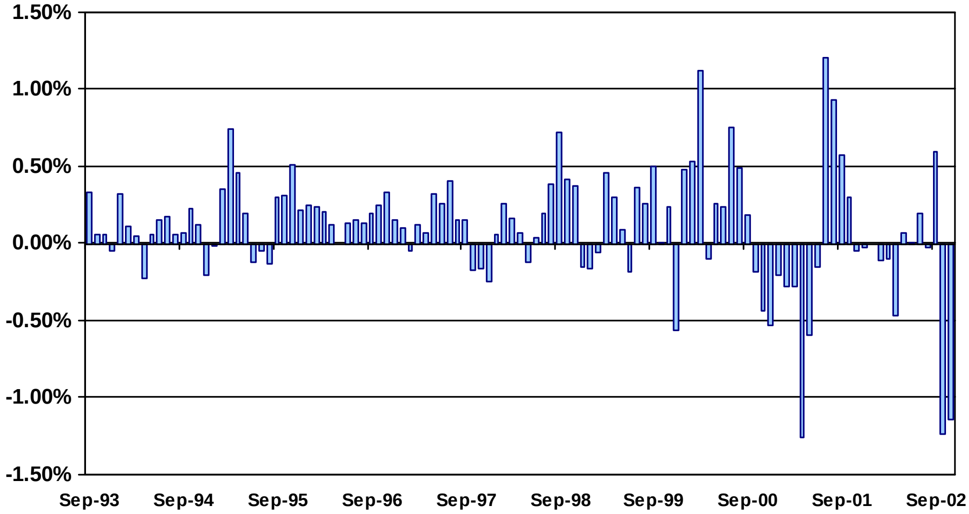
Impact on Performance

We compared index returns on an after tax basis, adjusting the national index to reflect the impact of the state tax. Chart 2 depicts the excess return of the California index compared to the National Index. Despite the yield volatility California bonds outperformed throughout much of the 90's. Recently this has not been the case. In the 90's investors received a pre-tax yield premium for investing in California bonds. Since 1997, there has been no pre-tax yield premium. At some points there was no after tax yield benefit. When the state got into financial difficulty, investors had no "cushion" of protection and thus were exposed to risk if a financial crisis occurred.

California Minus 7-Year Municipal Index
Rolling Quarterly Returns*
9/30/93 - 11/30/02



* Returns have been adjusted for California state taxes.

Source: Lehman Brothers

Since 2000 investors have experienced significant periods of underperformance even after the "tax advantage" of California bonds is taken into consideration. We believe this trend will continue until California yields rise sufficiently to reflect the state's weakened credit condition. During that adjustment period investors are likely to continue to benefit from a nationally diversified portfolio.

Lessons for Investors

The lessons of the California Utility Crisis and the subsequent deterioration of California's financial situation are applicable to municipal investors in all states:

- Yield relationships fluctuate, and investors need to compare present relationships and history.
- When relationships are low investors are exposed to potential underperformance if credit deteriorates or other conditions change.
- Events such as Orange County, the Utility Crisis, or the 9-11 attacks are not predictable and the best defense is state and sector diversification.
- Active management can assess both relative yields and credit conditions, and modify the allocation between in-state and out of state bonds.
- Taxes should be incorporated in the investment evaluation; however, avoidance of tax payments cannot drive the decision process. Out of state bonds should not be overlooked.