



MARKET COMMENTARY

Tax, Revenue, and Grant Anticipation Notes: A less prudent choice in a challenging market environment

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The contemporary investment environment can be likened to the challenges of a chess game; there is a random rotation of new players, a stream of new rules with the timer counting down, and the need for brilliant new strategies in combination with a resurgence of some very traditional play. An integral part of building new strategies is determining appropriate investment vehicles and the correct rebalancing of portfolios. Our role is to meet these challenges and master the best moves possible for our clients. There are many types of debt in the municipal market. The debt structure in question is the “anticipation note.” These are like bridge loans anticipating an expected revenue stream to a municipality or waiting for a bond deal to be issued and settled. Note the key word “*expected*.” This short-term financing comes in many forms *anticipating* revenue from taxes, bond issues, federal or state grants, etc. This past year several bond anticipation notes became an added expense to some municipalities because the expected cash receipts from the anticipated bond deal never came to fruition. It was not uncommon to see a bond deal cancelled. The dilemma here is if the anticipation notes are issued and the municipality does not receive the revenue stream expected to pay off the notes, what happens to the bond holder? Or the overall debt rating of the issuer? Or the reserve funds?

During 2008, investor attention was quickly drawn to municipalities suffering from falling revenue streams. Real estate tax transfer receipts were down significantly. Job losses began to deplete sources of income taxes. Foreclosures interrupted timely cash flows on taxes due. Corporate taxes stalled. In response to the loss of revenues, some municipalities began increasing fees and fines, such as dog licenses, building permits or parking tickets. We saw states and even counties institute rolling lay offs. California’s current budget situation is a perfect example; among other things the State pushed a pay period into the next fiscal year to meet the current year’s budget. Philadelphia is considering laying off 1,000 police officers, and closing libraries and recreation centers. Alas, these increased fees, fines and creative cut backs can not come close to replacing the lost revenue streams.

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Reserve funds are being tapped to make up for shortfalls. Schools have cut back on budgets and expansion projects, as did sewer systems, townships, counties, even states. Almost all municipalities have been hit by revenue shortfalls. With all tax receipts in a questionable status as well as state and federal flow through of “pledged” funds to municipalities (including states waiting on federal grants), it has not been prudent to purchase these types of debt instruments. The question of ability to pay or financial stability of a municipality forced to draw on reserves remains in question. During “normal” economic times, certain anticipation notes would be a reasonable short-term investment. However, in today’s challenging economic environment, Davidson has, for now, eliminated them from the list of allowable investments for our clients. If you would like to discuss this type of investment in greater detail, please contact your portfolio manager or Mary Talbutt-Glassberg on our fixed income desk.