



Guiding Portfolio Strategies

McDONNELL INVESTMENT
MANAGEMENT, LLC

For Immediate Release

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**MEDIAN ANNUAL PENSION FUNDING CONTRIBUTIONS
FOR U.S. CITIES NEARLY TRIPLE FROM 2003 TO 2007;
MEDIAN AGE OF PLANT AND EQUIPMENT JUMPS**

*Cities and states face increasing structural challenges
as tax revenues slow, says McDonnell Investments*

OAK BROOK, Illinois, (September 11, 2008) – The annual amount of money that must be set aside by U.S. cities to meet future pension fund obligations has nearly tripled over the past five years, rising from a median of \$1.282 million in 2003 to a median of \$3.397 million in 2007, according to data analyzed by McDonnell Investment Management, LLC (“McDonnell”), an Oak Brook, Illinois-based fixed income asset management firm. McDonnell looked at data on over 350 cities of all sizes from across the U.S.

In addition, the study found that the median average age for plant and equipment in these same cities had increased by about 10 percent over that same period, from 10.7 years in 2003 to 12 years in 2007.

“Cities are facing increased financial demands for pensions and capital equipment, even as a slowing economy is reducing available revenues,” said Richard Ciccarone, Managing Director and Chief Research Officer at McDonnell. “This in turn will continue to put pressure on municipal credit quality.”

Municipal bond insurance at lowest levels since 1988

McDonnell noted that even as credit quality is declining, the share of the new issue municipal bond market covered by insurance has continued to fall, reaching levels not seen since 1988, with just 21 percent of the new issue market being sold with insurance so far this year, compared to 48% for the same period in 2007, and an average of 42% for the last 20 years.

“The decline in new issue insurance shifts the credit burden and underlines again the importance of research for investors in this market,” said Ciccarone.

Ciccarone noted that there is an active movement now under way among ratings agencies, some state and local officials, and some members of Congress regarding the wholesale upgrade of municipal bond ratings, based in part on an overall governmental municipal default rate that has averaged less than one percent over the past 30 years. Once fully implemented, bond ratings on most traditional state and local governments would be lifted to triple-A or double-A levels.

While recent default trends may support this, a look at the historical record suggests caution is warranted, according to Ciccarone, who noted that the municipal bond ratings system as it is currently applied is based on the total 20th century default history, which includes the Great Depression, a period that saw a major spike in bond defaults. Data on Depression-era defaults was compiled and analyzed in a well-known 1964 study conducted by George Hempel ("The Postwar Quality of Municipal Bonds"). In the study, Hempel found that there were as many as 3,252 total municipal defaults at the peak of the Depression in 1935, with the vast majority of these involving special purpose and special district bonds. Hempel noted that the volume of defaults was significantly higher than had been anticipated at the time by market participants, and that of the defaulting bonds, nearly half were rated triple-A in 1929, and 78 percent were rated double-A or better.

"While the Hempel data shows what can happen under extreme circumstances, we are not expecting to see those levels of default today," said Ciccarone. "In some ways, however, weakening conditions today, especially related to real estate values, pose a future risk as a result of the growing liabilities for outstanding debt, pensions and other retirement benefits, and aging infrastructure. We believe that the current move to recalibrate the existing municipal bond ratings structure should be undertaken with great care, if at all."

Shifting the analytical burden

Ciccarone noted that in the past there was a tendency on the part of investors to assume that the bond insurers did much of the due diligence on new issue municipal debt. Going forward, the burden of analyzing credit quality will fall more clearly on the investment manager and on third-party research providers.

"Historically, municipal bond insurance has played an important role in providing investors with an extra measure of confidence in the market," said Ciccarone. "With thousands of outstanding issues, and hundreds of new issues coming out every year, most investors simply don't have the resources to do the kind of in-depth analysis needed to get an understanding of the potential credit risk."

“Given current market conditions, we don’t expect new issuance bond insurance to return to previous levels any time soon,” said Ciccarone. “As a result, the ability to conduct independent research on the underlying credit quality of the issuers will assume an increasing importance in the municipal markets over the next several years,” Ciccarone concluded.

About McDonnell Investment Management, LLC

McDonnell Investment Management, LLC is a private fixed income asset management firm based in suburban Chicago with approximately \$12 billion in assets under management as of June 30, 2008. McDonnell manages a wide range of fixed income assets across a diverse client base. McDonnell is 100 percent owned by its employees and is an SEC registered investment adviser. More information is available at www.mcdmgmt.com.

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