Robert S. Waas
RSW Investments, LLC
47 Maple Street
Suite 304
Summit, NJ 07901-3647
rwaas@rswinvestments.com

Kentucky Municipal Bond Case: Davis vs. State of Kentucky

Overview of the Case

The Supreme Court heard arguments on November 5, 2007 to determine whether a state violates the Commerce Clause of the U.S. Constitution when it taxes the coupon income on out-of-state municipal bonds, but does not tax the interest earned on bonds issued in its own state. The case was originally filed in 2003 by George and Catherine Davis, a couple from Kentucky who alleged that their state is unconstitutionally interfering with interstate commerce by only permitting tax preferences for Kentucky-issued bonds. While a lower state court negated this claim, the Kentucky Court of Appeals overturned the decision by the lower court, determining that the tax system was unconstitutional because it favored in-state bonds. This sets the table as Kentucky is now appealing to the U.S. Supreme Court. Please refer to our previous report issued in May 2007 entitled “Constitutionality of State Tax Statutes Favoring In-State Municipal Bonds is being challenged”

Is RSW handicapping the issue?

We believe that it would be an exercise in mental gymnastics to opine on how the Supreme Court will rule. As with many Court cases, prominent legal minds will weigh in with diverging views on the outcome with all arguments seeming plausible. Rather than ponder and pontificate the outcome, we will continue to assess risk and implement transactions that can be executed on a cost effective basis to mitigate the potential effects of such a change.

Risk Assessment

First, let’s address the impact to our client’s who can be the most affected: On the top rung of the ladder are investors who are positioned in State Specific portfolios in high tax states. For example, New York and California. Next, are clients with State Preference Portfolios in high tax states.

Why are these clients the most affected?

Historically, investors have “paid up” for bonds issued in higher tax states as they had a greater financial incentive to shelter their coupon income. If the state tax preference is eliminated in a post “Davis vs. Kentucky world”, the benefit offered by “specialty state” securities would be eliminated. With state tax considerations out of the equation, an assessment of relative value amongst issuers will be driven more by the credit worthiness of the issuer than by a need to invest in one’s own state of residence. This should raise the yield on specialty state bonds (price decline) to equalize their relationship with bonds of no or low tax states. In its simplest form, a California Water and Sewer 5% coupon, “AA-rated”, 15-year maturity bond should now trade at a similar yield as a Florida (no state tax) bond with the same security characteristics.

Now let’s try and quantify the risk

For analysis purposes we will look at the potential market impact on a hypothetical California Specific and a hypothetical New York Specific portfolio. Here, the impact should be the greatest as CA and NY are among the states with the highest income tax rates. We

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begin by assuming that the yield of the two specialty states lose their tax preference and their yields subsequently rise to match the level of Florida securities. Again, the state of Florida does not impose a state income tax. Specifically, we used a six month average yield[1] for the three states and compared their spread differences to gauge the risk. As can be seen in the chart below, the risk to California investor is twice that of New York investor. Yields on California tax-exempt bonds could rise by 10 basis points, whereas the New York exempt securities may only witness a 5 basis point increase.

Using the average duration (measure of interest rate sensitivity) of our current Market Duration composite, a 10 basis point rise in yield would translate into a 51 basis point reduction in the portfolio's total rate of return for a California resident. The impact is 25 basis points for clients invested in a New York Specific Portfolio.

	NY	CA
Market Duration Composite MDW[2] (Yrs)	**5.05**	**5.05**
State spread widening in basis points	**0.05%**	**0.10%**
(MDW x Spread Widening) = Portfolio Basis Point Impact	**0.25%**	**0.51%**
Hypothetical Account Size	**$1,000,000**	**$1,000,000**
Hypothetical ($) Impact	**$2,525**	**$5,050**

Should clients feel compelled to act?
Aside from the work above, there are other factors that need to be considered and quantified. To begin, we should quantify the cost of liquidating specialty state bonds and re-investing the proceeds in "National" securities. In addition to the transaction costs discussed below, the investor would now incur a tax liability on the newly acquired out of state bonds. To calculate this cost it was assumed that we executed the sales today (settlement date) and held the National securities for a period of six months (approximate date when the Supreme Court is expected to rule).

Cost of Conversion for Six Months

	NY	CA
Yield to Worst	**4.22%**	**4.17%**
Maximum State Tax Rate	**7.70%**	**10.30%**
[YTW x (Max State Tax / 2)] = 6 Month Tax Liability	**0.16%**	**0.21%**
Bid / Ask Spread[3] Transaction Cost (Bps)	**0.06%**	**0.06%**
Total Restructuring Costs (Bps)	**0.22%**	**0.27%**
Hypothetical Account Size	**$1,000,000**	**$1,000,000**
Hypothetical Total ($) Impact	**$2,225**	**$2,748**

As can be seen above, the total restructuring costs could amount to 27 basis points for California investors and 22 basis points for New York investors. Given the "too close to call" outcome, it seems a rush to shift strategies may be unwarranted. Please also be mindful that the analysis does not include other factors that could increase the cost to shift, i.e. the realization of capital gains upon sale. While the level of embedded capital gains will vary by account, this could only serve to increase the cost of shifting state preference.

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Bottom-line

The Davis vs. Kentucky case clearly has the potential to impact the dynamics of the Municipal market. Although the outcome of the case could create meaningful future relative value opportunities in the marketplace, we feel that at the current juncture, the risks of embarking on a full scale portfolio restructuring may be premature. The costs associated with repositioning assets are not insignificant and should be weighed against the potential reward of benefiting from a "coin toss" outcome should the Supreme Court choose to rule against the Davis'.

[1]Source: Lehman Brothers Municipal Bond Managed Money NY, CA, & FL Indices
[2]Modified Duration to Worst is a measure of interest rate sensitivity
[3]Assumes a $3 per bond bid / ask spread

This report has been prepared by, and reflects the views as of this date of, RSW Investments, LLC [RSW hereafter]. RSW's views and opinions are subject to change. Investors should consult their attorney, accountant, and/or tax professional for advice concerning their particular situation.

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The Lehman Brothers Municipal Managed Money Index is a rules-based, market-value-weighted index engineered for the tax-exempt bond market. To be included in the index, bonds must be rated Aa3/AA- or higher by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be at least Aa3/AA-. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have been issued within the last five years, and must be at least one year from their maturity date. AMT, hospital, housing, tobacco, and airline bonds, along with remarketed issues, taxable municipal bonds, floaters, and derivatives, are excluded from the benchmark.