BELLE HAVEN INVESTMENTS
FIXED INCOME SPECIALISTS

# MUNICIPAL BOND MARKET UPDATE

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## TIGHT SUPPLY

*Fixed income markets rallied to start 2014 as global equity markets shuttered over emerging market currency concerns. The S&P 500 fell over 3% while the Nikkei Index fell over 8%. The flight to safety caused Treasury yields to fall dramatically, municipals followed but slightly underperformed Treasuries. Limited supply helped fuel municipals as did positive mutual fund flows.*

features

CONTINUING CARE RETIREMENT CENTERS

In the 3 year range, municipal yields moved lower by 2 basis points to yield 0.49% while Treasury yields in the same range fell by 10 basis points to yield 0.67%. This puts municipal yields at 73% of the Treasury yield, up from 66% from the previous month.

In the 10 year range, municipal yields moved lower by 24 basis points to yield 2.53% while Treasury yields in the same range fell by 38 basis points to yield 2.65%. This puts municipal yields at 95% of the Treasury yield, up from 91% the month prior.

FIGURE 1: BARCLAYS MUNICIPAL INDEX RETURNS

| Index | MTD Total Return | YTD Total Return | Total Return 3 Month | Total Return 6 Month | Total Return 12 Month |
|---|---|---|---|---|---|
| Municipal Bond Index | 1.95 | 1.95 | 1.48 | 2.99 | (1.07) |
| 1 Year (1-2) | 0.07 | 0.07 | 0.21 | 0.46 | 0.75 |
| 3 Year (2-4) | 0.38 | 0.38 | 0.51 | 1.37 | 1.48 |
| 5 Year (4-6) | 1.05 | 1.05 | 0.83 | 2.16 | 1.39 |
| 7 Year (6-8) | 1.71 | 1.71 | 1.15 | 2.61 | 0.59 |
| 10 Year (8-12) | 1.89 | 1.89 | 1.00 | 2.93 | (0.49) |
| 15 Year (12-17) | 2.40 | 2.40 | 1.95 | 4.16 | (1.31) |
| 20 Year (17-22) | 2.61 | 2.61 | 2.44 | 4.07 | (2.45) |
| Long Bond (22+) | 3.09 | 3.09 | 2.17 | 3.56 | (3.93) |
| AAA | 1.50 | 1.50 | 1.15 | 2.84 | (0.26) |
| AA | 1.84 | 1.84 | 1.43 | 3.33 | (0.58) |
| A | 2.27 | 2.27 | 1.82 | 3.43 | (0.90) |
| BAA | 2.13 | 2.13 | 0.92 | (0.94) | (6.47) |
| Puerto Rico | 1.28 | 1.28 | (4.97) | (13.83) | (21.21) |

Data Source: Barclays

| | 12/31/2013 | | | 12/31/2013 | | | 1/31/2014 | | | YTD Change | | Month Change | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | MUNI AAA | Treasury | % of Treas. | MUNI AAA | Treasury | % of Treas. | MUNI AAA | Treasury | % of Treas. | MUNI AAA | Treasury | MUNI AAA | Treasury |
| 3 yr | 0.51 | 0.77 | 66.23% | 0.51 | 0.77 | 66.23% | 0.49 | 0.67 | 73.13% | (0.02) | (0.10) | (0.02) | (0.10) |
| 5 yr | 1.24 | 1.74 | 71.26% | 1.24 | 1.74 | 71.26% | 1.10 | 1.49 | 73.83% | (0.14) | (0.25) | (0.14) | (0.25) |
| 10 yr | 2.77 | 3.03 | 91.42% | 2.77 | 3.03 | 91.42% | 2.53 | 2.65 | 95.47% | (0.24) | (0.38) | (0.24) | (0.38) |
| 30 yr | 4.19 | 3.97 | 105.54% | 4.19 | 3.97 | 105.54% | 3.85 | 3.60 | 106.94% | (0.34) | (0.37) | (0.34) | (0.37) |

Data Source: Bloomberg

In the 30 year range, municipal yields moved lower by 34 basis points to yield 3.85% while Treasury yields in the same range fell by 37 basis points to yield 3.60%. This puts municipal yields at 106% of the Treasury yield, up from 105% the month prior.

Heading into tax season we expect municipals to garner additional support. If supply continues to fall short of investor demand, amidst continued mutual fund inflows, municipal investors could see continued gains. It is important to note that are several headwinds facing the municipal market. First and foremost are the negative headlines out of Puerto Rico. Last and certainly not least is the battle in Detroit and the lasting affects regardless of what outcome is reached.

# CCRCs

*Many Continuing Care Retirement Communities (CCRCs) are financed with tax-exempt bonds, despite nongovernmental ownership. CCRCs offer higher yields, which can make them attractive additions to a portfolio, however, because they have no tax support, they also entail higher risk. Care must be taken in selecting CCRC bonds.*

We view CCRCs as a hybrid of the healthcare and real estate sectors with many of the same risks and concerns the market has see in other municipal real estate sector bonds. So far the sector has experienced a small increase in defaults, but we expect defaults to grow over the next few years.

## WHAT ARE CCRCs?

CCRCs are institutions that offer a continuum of care. Residents move into an independent living unit (ILU) until there is a need to move to the assisted-living portion of the campus. When more care is needed, the resident moves into the skilled nursing facility. Skilled nursing facilities often offer an array of services including memory care and hospice, and are akin to a typical stand-alone nursing home. ILUs can vary from apartments on a suburban campus to detached homes, or even high-rise apartments in a city setting.

CCRCs charge an entry fee, monthly fee and sometimes additional health care fees under various plan types. For each CCRC the plan with the highest entry fee usually covers unlimited care. The monthly fees cover most meals, housing and other amenities and are not dependent on which area the resident is currently living. We have seen the entry fee for this type of plan vary from $150,000 to $600,000. And this is where the real estate nature of the sector comes into play.

## CCRCs AS A REAL ESTATE TRANSACTION

In order to afford the entrance fee, potential residents sell their homes. CCRCs know this of course, and set their rate plans accordingly. In an effort to compete for residents, facilities began to build or remodel with expensive amenities to attract the new retirees including recreational facilities and social activities, appealing to more affluent residents by cultivating a resort or country club-like ambiance.

Imagine in 2005, a couple tours a new luxury facility, thrilled to realize they can afford the higher entry fee due to the $600,000 market value of their home. They reserve their spot with a deposit and in 2007 sell their home and move in. The new CCRC begins to fill up with similar couples.

But what if that couple didn't plan to move in until 2009? Due to the bursting of the housing bubble, their home now sells for $400,000 and the facility is now less affordable. Suddenly, people are canceling their contracts, even walking away from nonrefundable deposits. Even for the couple that moved into the CCRC in 2007, their investment portfolio has likely shrunk making the monthly payments more challenging to meet.

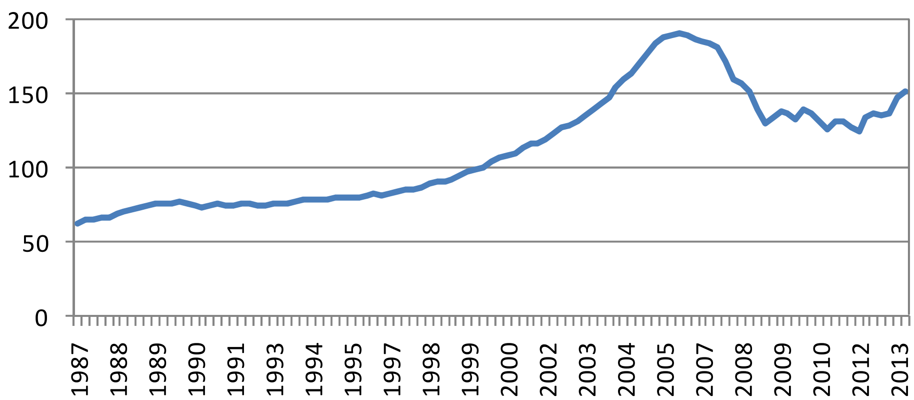
## VINTAGE

In terms of considering which CCRCs are more likely to experience financial stress, one of the many factors to consider is vintage. A newly created CCRC or one that made major upgrades and increased amenities in 2007 is waving a red flag. These CCRCs likely anticipated residents able to afford higher entry and ongoing charges than the homeowners could actually afford once it came time to sell their homes. However, CCRCs built or upgraded in earlier years are also a concern. While they might have had no problem filling up in the early 2000's, as vacancies occur, it becomes more difficult to find potential residents to fill the spots as home values dropped on average 30% between 2007 to 2009. Over the past five years, the CCRC market saw occupancy rates drop, and with them, debt service coverage.

## HOME VALUES

Currently, it appears that in many areas in the US, home prices have stabilized and even increased, but they are still well below the 2005-2007 price range. The S&P/Case-Shiller Index shows that overall, homes are currently priced at the same level as they were in 2004. Barring another real estate bubble, that gives us an indication of which CCRCs are most at risk due to the decrease in housing costs. This means filling vacancies in many of these homes will be a longer term challenge.

FIGURE 2: S&P CASE-SHILLER U.S. NATIONAL HOME PRICE INDEX




Data Source: S&P/Case-Schiller

## DEFAULT STATUS

CCRCs have always been considered a higher-risk sector than most municipal bonds. The past few years have shown weakening in margins, debt service coverage and important liquidity ratios according to CARF-CCAC, a nonprofit which collects such data. As we stated earlier, we have not only seen an increase in defaults, but we expect the default rate to continue to rise. Retirement projects represent 9% of all currently uncured defaults in the municipal market; but they represent 14% of new defaults in the past year. Currently, there are about 1,900 CCRCs, before the recession there were about 2,200.

We do not think that this is the end of the CCRC sector, but that the sector will need to adapt. Already, many lenders are looking for larger liquidity cushions and stronger covenants. From a resident perspective, refundable deposits are often available. Eighty percent of CCRCs are run by nonprofit entities, often with religious affiliations. These organizations historically were run with thin margins and are learning to manage with the new reality of higher vacancy rates.

### OTHER CONSIDERATIONS

When analyzing a CCRC, we take all the usual factors into consideration, including management, financials, competition, Medicare and Medicaid reliance, waiting lists, and reputation for quality care -- factors with which our readers are familiar. This article does not discount the importance of weighing those issues. Instead, we are focusing on the often overlooked real estate transaction characteristics of CCRCs and why we believe that current housing prices indicate that defaults are likely to rise in the sector in the upcoming years.

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