

## MUNI MARKET UPDATE

May 10, 2010

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### THE COST BURDEN OF INCARCERATION

By [Larry Levitz](#)

As the states grapple with daunting budgetary deficits, they are increasingly focused on reducing expenditures. One of the fastest growing budget items is in the area of corrections. State prison population nationwide has exploded over the past three decades and now totals

1.4 million inmates. The annual cost of incarceration for states exceeded \$50 billion in 2008, consuming on average 7.2% of state general fund expenditures.

Investors should be aware of this issue because of the impact these costs have on a state's credit. The maintenance and operation of

prisons is a significant spending item that can be difficult to cut due to public concerns over crime and overall safety. Correctional costs crowd out spending in other areas such as education and health care that effect a state's long term viability. How states manage these costs and their willingness to adopt

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### THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure
<b>Tuesday, May 11</b>					
11:00AM	21,300M	UR/UR	Calvert Co	MD	2011-2020 BQ
			14,640M - TAX EXEMPT		2021-2025
			6,660M - TAXABLE - BABs		
11:00AM	9,044M	UR/UR	Silver Lake RSD	MA	2011-2027 BQ
		AAA/			
11:00AM	80,000M	AAA	Orange Co Sanitation Dist - TAXABLE	CA	2034-2040
11:00AM	110,000M	Aa1/UR	Alabama	AL	2013-2032
		AAA/			
11:30AM	60,000M	AAA	Virginia Beach	VA	2011-2030
12:00AM	55,125M	Aa1/AA	Richland Co Sch Dist #1	SC	2013-2026
12:30PM	10.490M	A2/A	Indian Wells Redevelopment Agency	LA	2011-2034
<b>Wednesday, May 12</b>					
11:00AM	492,665M	Aa1/AA+	Virginia Transportation Brd	VA	2011-2035
11:30AM	90,160M	Aa2/AA+	Virginia Beach Dev Auth	VA	2010-2022
12:30PM	23,140M	Aa2/AA+	Virginia Beach Dev Auth	VA	2010-2019
<b>Thursday, May 13</b>					
11:00AM	1,000M	UR/UR	C/O Troy	NY	2011-2015 BQ

Click [here](#) for calendar updates.

When Exchange Traded Funds ("ETFs") were first permitted in 1993, after a fund sponsor received U.S. Securities and Exchange Commission (SEC) exemptive relief from various provisions of the Investment Company Act of 1940 that would not otherwise allow the ETF structure, they were

In early 2008, the SEC first granted exemptive relief to several fund sponsors to offer fully transparent actively managed ETFs, provided they met certain requirements.

By the end of 2009, the

There are a handful of active ETFs that have a municipal securities strategy. These funds are

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Having been fully operational since March of this year, Rockfleet has participated as member in 65 competitive transactions totaling \$1.9 billion in par value. As a result of presenting our qualifications to the City of New York, we are pleased to announce that Rockfleet

has been added to the selling group for the City of New York's General Obligation bonds, as well as securities issued by the New York City Transitional Finance Authority and the New York City Municipal Water Finance Authority.

In addition to this important appointment, we continue to respond to RFPs on a national basis, seeking co-manager appointments in order to provide access to new issue product, in addition to secondary offerings, to our ever-expanding customer base. ♣

European sovereign debt woes continued to influence the fixed income markets this week and Treasury yields moved sharply lower in the flight-to-quality trade driven by both the uncertainty in the progress of the EU and IMF bailout of Greece and volatility in the equity markets.

Rate changes for benchmark Treasury yields for the week were:

	5/3 Open- ing <u>Rates</u>	5/7 Rates 3:00 <u>Friday</u>
3 year	1.68%	1.29%
5 year	2.41%	2.16%
10 year	3.69%	3.42%
30 year	4.55%	4.27%

Tax exempt yields were largely unchanged in the front end of the curve while longer dated maturities outperformed but all sectors severely underperformed the rally in the U.S. Treasury market.

As measured by MMD, 5

year yields were unchanged at 1.72%, 10 year rates rose 1 basis point to 2.95% while 20 year and 30 year yields ended the week 5 basis points lower to 3.73% and 4 basis points lower to 4.01%, respectively.

Secondary retail flows were subdued across the curve as investor focus remained fixed on the primary market and the gyrations in the equity markets. ♣

The 30-day visible supply of municipal bonds totaled \$10.565 billion, up \$725.9 million from the previous session, according to The Bond Buyer.

That comprises \$1.674 billion of competitive bonds, which is down \$91.6 million and \$8.890 billion of negotiated bonds, which is up \$817.5 million.

**Week of May 3, 2010**

Total supply: \$7.52B

Taxable/BABs: \$1.09B

Tax-Exempt: \$6.43B

**Week of May 10, 2010**

Total supply: \$7.57B

Taxable/BABs: \$2.08B

Tax-Exempt: \$5.48B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters.  
5/7/2010.

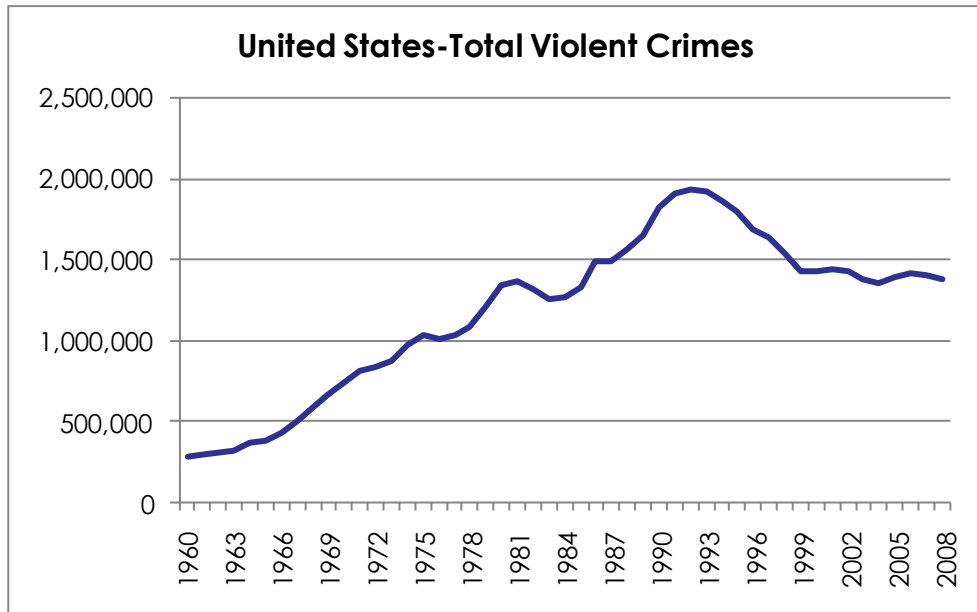
- March 2016 -								
Sun	Mon	Tue	Wed	Thur	Fri	Sat		
	1	2	3	4	5	6	7	8
9	10	11	12	13	14	15	16	17
18	19	20	21	22	23	24	25	26
27	28	29	30	31				

## THE COST BURDEN OF INCARCERATION (CONT'D)

alternative methods to incarceration will signal their ability to handle their broader budget issues.

The purpose of this article is to give investors a sense of the underlying causes behind the growth of the inmate population and examine its impact on state budgets.

The last section will summarize state efforts to lower these costs and suggest some resources to which investors can refer to track inmate and cost data.



Source: Office of Bureau of Justice Statistics.

### Historical Perspective

U.S. attitudes towards crime and punishment over the past four decades were an outgrowth of rising rates of violent crime and drug use during the late 1960s and early 1970s. Beginning in 1967, violent crime rates began to skyrocket, more than doubling between 1966

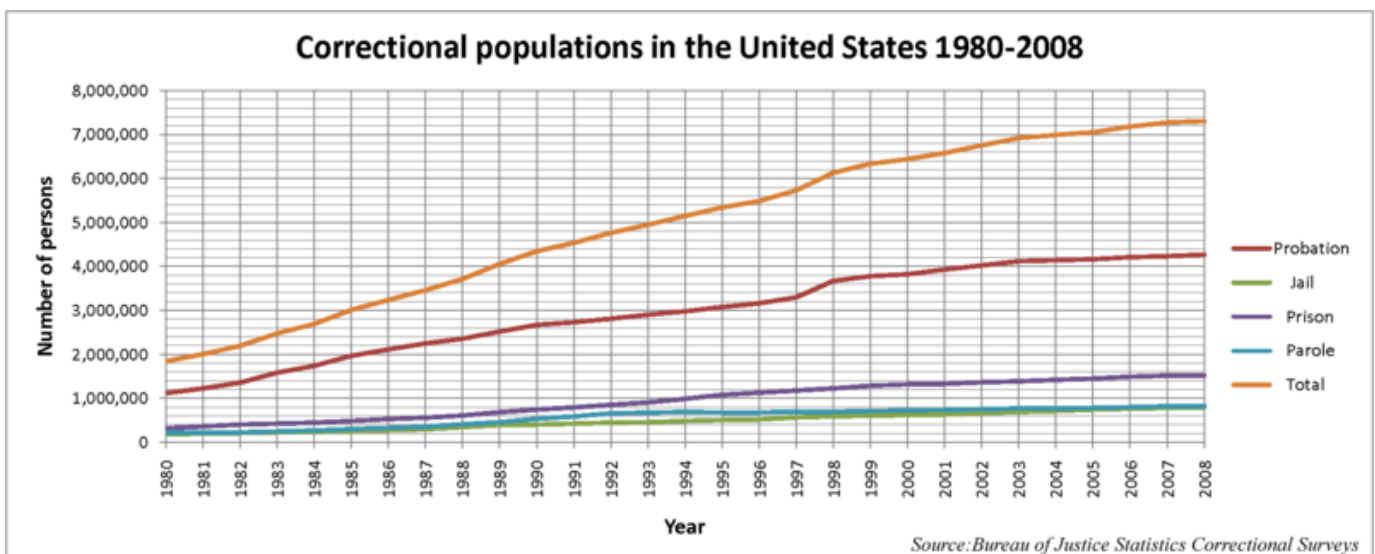
and 1974. With growing disillusionment over the rehabilitative methods towards criminal behavior employed during the prior decades, the public was much more receptive to the 'tough on crime' rhetoric of politicians. Prisons, by isolating criminals from society, served to allay the

public's fear of the growing crime threat. Increased resources at the federal level were directed towards law enforcement. States, in response, enacted a series of laws designed to send more criminals to prison such as expanding the list of crimes punishable by incarceration, placing

greater restrictions on parole, and lengthening prison sentences.

In the 1990s, another spurt in crime rates led many states to institute long minimum sentences for a wide range of crimes. These acts in-

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## THE COST BURDEN OF INCARCERATION (CONT'D)

cluded the widely adopted "three strikes and you're out" legislation and "truth in sentencing laws, the latter requiring prisoners to serve most of their sentence before becoming eligible for parole. Together, these measures led to a vast expansion of both the state and federal prison population. In just 20 years, between 1987 and 2007, the number of U.S. prison inmates tripled making the U.S. prison system the largest in the world.

### 9% Annual Growth Rate in Correction Expenditures

By 2008, as state prison population reached 1.4 million, the largest inmate populations were located in Texas and California (over 170,000

each), Florida (97,000), New York (62,000) and Georgia (55,000).

State spending on corrections rose commensurately. According to the Federal Bureau of Justice Statistics, direct state expenditures on corrections between 1980 and 2006 increased from \$4.3 billion to \$40.4 billion, a 9% annual rate of growth (including inflation).

### Over \$1 Billion Spent Annually in Correctional Facilities' Operations

Next to Medicaid, correction expenditures were the fastest growing item in State budgets. California led the nation in prison costs spending \$9.7 billion in fiscal 2008. Overall, 17 states expended over \$1 billion for their correctional opera-

tions.

### Prisoner Medical Care & Health Costs

Prisoner medical care has also contributed to prison cost inflation. Prison health care costs, as with the rest of the country, have skyrocketed over the past 15 years. Furthermore, the longer sentences imposed over the past three decades are creating a growing population of elderly prisoners with much greater medical needs.

Estimates are that overall inmate costs for older prisoners are two to three times higher than with younger prisoners.

### States Struggling with Financial Burden

For years state officials have recognized the heavy financial burden prison costs were placing upon their taxpayers. Since the mid-1990s and especially after the fiscal woes of the early 2000s, a number of states in an effort to contain costs have amended their criminal statutes or changed sentencing policies. Beginning in 2004, at least 13 states have created or expanded less costly community options for nonviolent drug offenders. These efforts are accelerating as the states are

## RESOURCES FOR ADDITIONAL INFORMATION

To monitor how states are managing their correctional systems, the Pew Center on the States

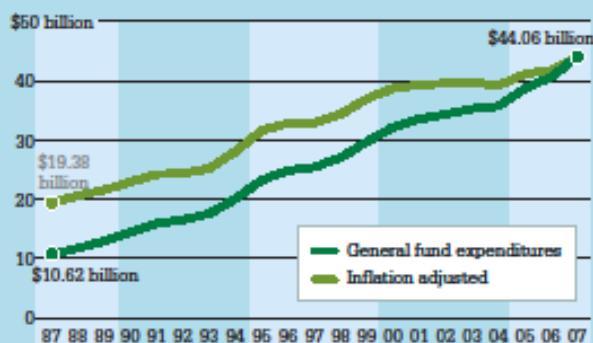
([www.pewcenteronthestates.org](http://www.pewcenteronthestates.org)) provides regular reports and updates on inmate population trends on an aggregate as well as individual state basis and evaluates how states are managing the associated costs.

Another useful resource is the National Association of State Budget Officers ([www.nasbo.org](http://www.nasbo.org)), which releases annual reports on state expenditures and compares total and individual state spending on corrections by year.

Finally, the Federal Bureau of Justice Statistics (<http://bjs.ojp.usdoj.gov>) provides a broad array of prison and crime statistics, although some of the information is dated.

### TWENTY YEARS OF RISING COSTS

Between fiscal years 1987 and 2007, total state general fund expenditures on corrections rose 315 percent.



SOURCE: National Association of State Budget Officers, "State Expenditure Report" series; Inflation adjusted figures are based on a reanalysis of data in this series.

NOTE: These figures represent state general funds. They do not include federal or local government corrections expenditures and typically do not include funding from other state sources.

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## THE COST BURDEN OF INCARCERATION (CONT'D)

struggling to balance their budgets.

### Three Cost-Reducing Strategies

States are focusing on three strategies to pare down correctional costs.

#### Reduce Prison Admissions

This can be accomplished either on the front end by curbing new admissions or on the back end by reducing recidivism and parole revocations.

Strategies to lower the

front end admissions rate include diverting low-risk offenders to community programs rather than prison, eliminating mandated prison sentences for certain crimes, and providing judges with more discretion in sentencing decisions. Many states are looking at ways to divert low risk offenders into non-prison alternatives.

In 2007, Texas set up a network of residential and community based

treatment and diversion programs providing less costly and generally more effective treatment than incarceration. It also expanded parole grants and shortened probation periods. Consequently, Texas' prison population has started to shrink for the first time in many years.

The costs of incarceration compelled Michigan to reform its narcotics laws, eliminating most mandatory sentences for drug

offenders.

States are also providing more support to parolees in an effort to keep them from returning to prison. California offers grants to counties that succeed in reducing the rate of parole violators that are sent back to prison.

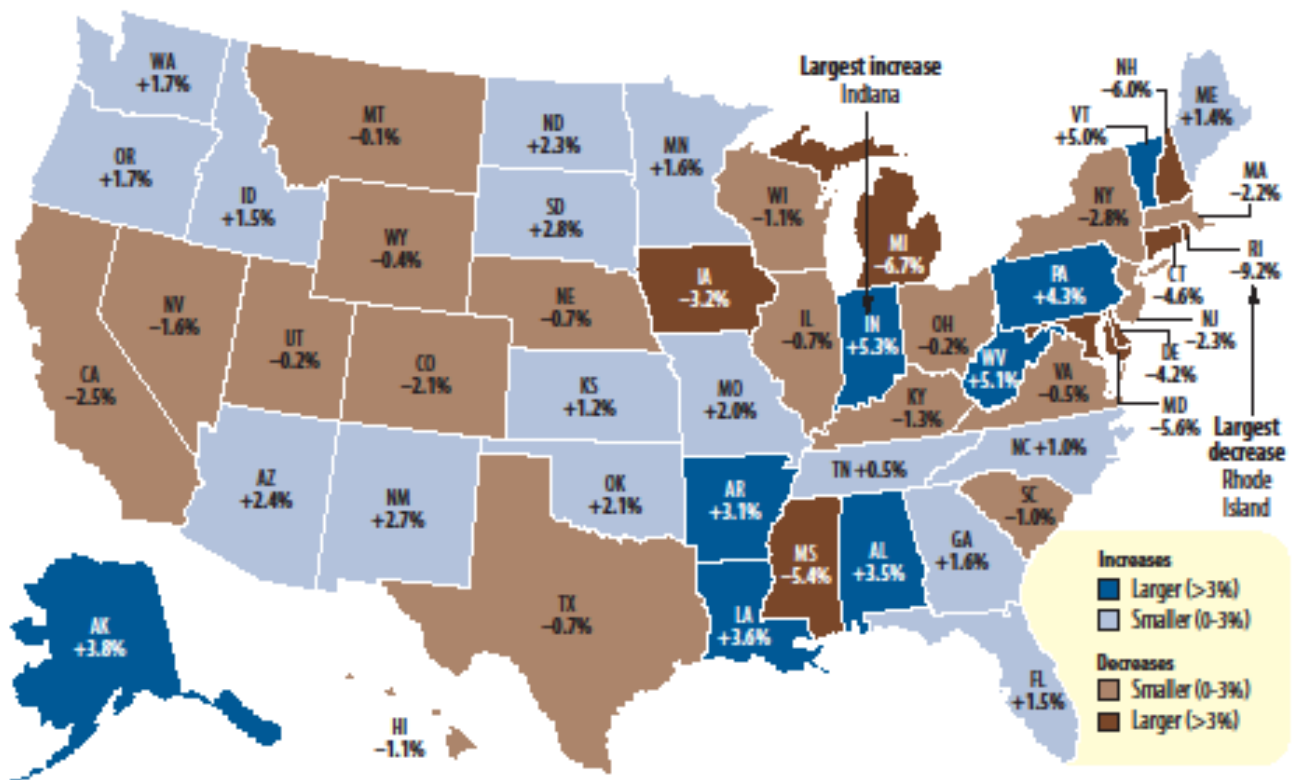
#### Reduce the Length of Prison Terms

In recent years, states have been lowering or eliminating mandatory

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## STATES MOVE IN DIFFERENT DIRECTIONS

Percent change in state prison populations, 2008–2009.



NOTE: Percent change is from December 31, 2008 to January 1, 2010 unless otherwise noted in the jurisdictional notes.

SOURCE: Pew Center on the States, Public Safety Performance Project

## THE COST BURDEN OF INCARCERATION (CONT'D)

prison sentences for lower level crimes. In addition, programs which reward good behavior with reductions in prison time have been shown to be effective.

Minnesota passed legislation that allows the court to disregard the six-month mandatory prison requirement in sentencing certain convicted drug offenders.

Pennsylvania instituted an innovative program called Recidivism Risk Reduction Incentive (RRRI) which gives judges the ability to issue a RRRI sentence to eligible persons with no violence or weapons offenses. RRRI sentences enable inmates to reduce their sentences if they attain certain milestones, such as completing required programs and maintaining good behavior.

Other methods of shortening prison time include expanding the accessibility of parole and accelerating medical or geriatric release. The State of Washington can now release low risk inmates that require costly medical treatment as a result of age or medical condition.

### Realize Operating Efficiencies

In addition to lowering prison counts and reduc-

ing sentence length, almost all states have been taking actions to reduce operating costs. Measures range from cuts in correctional staff and benefits to closing facilities.

States have also contracted with private companies to build and operate prisons. Although private prison advocates claim significant cost savings through privatization, the evidence is conflicting.

### Number of State Prisoners Declined for the First Time Since 1972

These measures seem to be paying off. In March 2010, the Pew Center for the States, in its [2009 annual survey of state prison population](#), reported that the total number of state prisoners declined for the first time in nearly 40 years.

While results varied widely among states with many continuing to gain inmates, the overall drop was slight, only 4,777 prisoners out of 1.4 million. Nonetheless, given the deep fiscal challenges facing the states, these results could very well signal the beginning of a different trend.

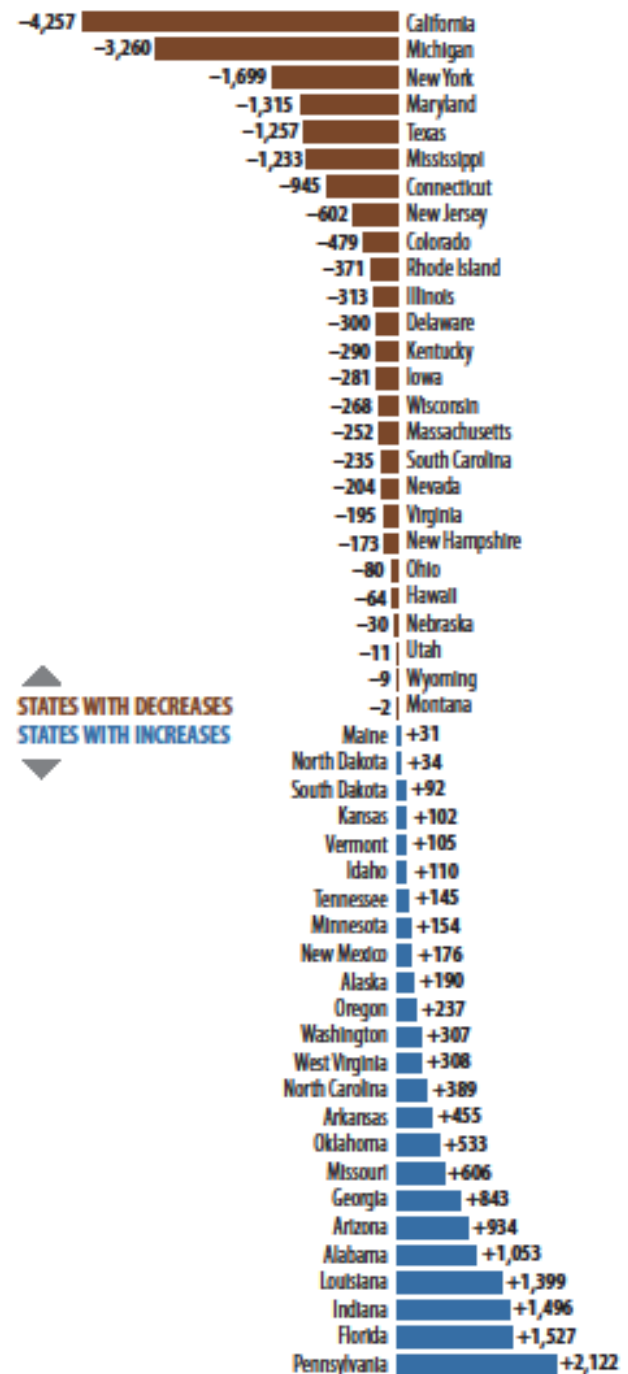
### Private Prison Industry

The private prison industry

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## PRISON COUNT DROPS IN 26 STATES

Absolute change in state prison populations, 2008-2009.



NOTE: Change is from December 31, 2008 to January 1, 2010 unless otherwise noted in the jurisdictional notes.

SOURCE: Pew Center on the States, Public Safety Performance Project



## THE COST BURDEN OF INCARCERATION (CONT'D)

in the U.S. was launched in 1984 as a cost efficient alternative to government-run prisons. Private prison advocates claim that the private sector builds and operates prisons less expensively than governments due to the use of non-unionized labor, flexible work rules, and more efficient prison designs.

Private prisons also offered government officials a more certain and rapid way of adding much needed prison capacity by allowing state officials to contract with private operators and thus avoid the voter approval requirements usually associated with the issuance of bonds for state-funded prison construction.

The private prison industry

expanded rapidly over the last 25 years to accommodate U.S. prison growth. According the Bureau of Justice Statistics, in 2005 private correction companies managed 12% of all federally sentenced offenders and about 6% of state prisoners.

Corrections Corporation of America (CCA) is the market leader with close to 50% market share. With 80,000 inmate beds in the U.S. market, CCA is the fifth largest prison operator in the nation after the federal government and three states. Other significant industry players are the GEO Group (formerly Wackenhut) and the Cornell Companies.

### Private Prison Bonds

Private prison construction has often been financed through municipal debt. The structure usually includes a lease between the governmental unit and the operator.

Under the lease, bond proceeds are transferred to the operator to construct the prison. The government makes lease payments, usually subject to legislative annual appropriation, to cover operating costs of the prison and debt service on the bonds.

### Leases with Government Guarantees

Most investment grade deals contain government guarantees that it will send a minimum level of prisoners to the new

facility. If the operator fails to perform, the government, in the bond documents, covenants to find a replacement operator or run the facility itself rather than close the prison.

### Leases without Government Guarantees

Investors should avoid leases for private prisons built on speculation, i.e. without a guarantee of future prisoners at the time of financing.

If prisoners fail to materialize, the government lessee will be less willing or unable to make the lease payments required to service the debt. A number of bonds in this category have encountered trouble or defaulted. ♣

## ACTIVELY MANAGED MUNI ETFs (CONT'D)

gathering assets quickly.

In April, PIMCO's Short Term Municipal Bond Fund (SMMU), with a net expense ratio of 0.35%, attracted more than \$10 million in assets, according to [ActiveETFs](#). SMMU has a market cap of \$12.98 Billion, with all assets having been added since its inception date of January 29, 2010.

Launched on the same day as SMMU, the Grail

Intermediate Municipal Bond Fund (GMMB), managed by McDonnell Investment Management, has a market cap of \$5.02 Billion, and the same net expense ratio as SMMU.

The PIMCO Intermediate Municipal Bond Fund (MUNI), available to investors since November 2009, has \$33.11 Billion market cap. MUNI also has a 0.35% net expense ratio.

### Upcoming Funds

Claymore Advisors recently filed details with the SEC on its planned Active National Municipal Bond ETF. Claymore expects to file a registration statement for this product in the near future.

Eaton Vance is also planning offerings in the short-term as well as intermediate municipal bond space.

Grail Advisors has confirmed that it's in talks with two fund companies in converting their mutual funds into actively-managed ETFs.

### Resources for More Information

The [Investment Company Institute](#) provide research, fact books and statistics on mutual funds and ETFs. ♣

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