california advisor

A Quarterly Newsletter to the California Investors Community
Winter 2003

current events

On with the Budget Debate!

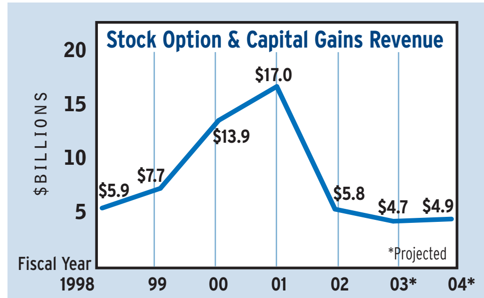
As the state grapples with the worst budget deficit in its history, deep budget cuts and higher taxes will undoubtedly affect the lives of all Californians. Faced with a $34.6 billion budget deficit over the next 18 months, Governor Davis has formulated a number of controversial proposals to cure the shortfall. The $96.4 billion proposed budget for fiscal 2004 incorporates $20.7 billion in spending cuts, $8.3 billion in tax increases and $5.6 billion in loans, transfers and deferments. Certainly the cuts will be painful and the tax increases will be hotly contested.

Despite the Legislature's Democratic majority, the Governor still needs six Assembly Republican votes and two Senate Republican votes to achieve the two-thirds vote required to pass the budget. The tension in Sacramento has heated up already. Inflammatory comments from outspoken legislators, such as calling Davis' proposed one-cent sales tax increase as necessary as a "hole in the head," accusing Davis of "cooking the books," and using phrases such as "over my dead body" provide color.

How Did the Numbers Deteriorate so Quickly?

The state's 2003 budget was balanced in September 2002. In late November 2002, the independent Legislative Analyst's Office projected that California would face a $21 billion budget shortfall for fiscal 2004. One month later, Governor Davis projected a $34.6 billion deficit for the very same budget. How could these numbers be so different?

At the heart of the problem is the precipitous decline in stock-related income. With a strongly progressive tax structure, California relies heavily on its wealthiest taxpayers for revenues; this



Source: Legislative Analyst's Office

leaves the state vulnerable to economic fluctuations. When the stock markets plummeted and the high technology bubble burst, revenues from capital gains and stock option income declined 65%, from $17 billion in 2001 to under $6 billion in 2002. Rather than reducing expenditures to match the declining revenues, state forecasters optimistically believed revenues would recover. They did not.

The main reason for the large gap between the results of the Legislative Analyst's study and the Governor's budget can be chalked up to forecasting differences. The administration simply had more conservative revenue and expenditure projections than did the Legislative Analyst's Office. A revised budget set forth by the Legislative Analyst's Office in January 2003 indicates a projected deficit of $26 billion, still significantly lower than the budget proposed by Governor Davis.

The Governor's Proposal: Tax Increases and Budget Cuts

Governor Davis' plan includes raising a variety of taxes including the state sales tax, personal income tax on the wealthy, and cigarette taxes. The state's portion of the sales tax would be raised from 5% to 6%. After adding on local taxes, the total sales tax could shoot up as high as 9.50% in San Francisco and 9.25% in Los Angeles. The state's income tax structure would change by adding two new income tax brackets for high-income individuals.

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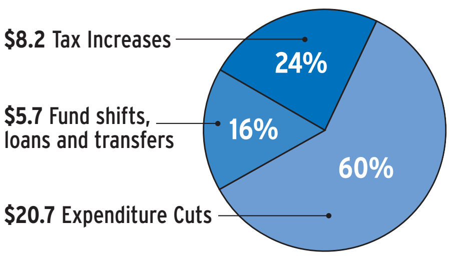
Currently the top rate is 9.3%. Under the proposed budget, personal income taxes would increase to 10% for single filers earning more than $136,115 and for couples earning more than $272,230. The top tax rate would rise to 11% for individuals earnings more than $272,230 and for couples earning more than $544,000. And, finally, the cigarette "sin" tax would rise by $1.10 per pack.

Under the governor's proposed plan, nearly every state program faces budget cuts. The areas hardest hit will be health care, social services and education. The health care sector would face $3.6 billion in cuts, resulting in the elimination of Medi-Cal benefits to about 570,000 low-income individuals. In addition, the state would no longer pay for some medical equipment, including hearing aids, glasses and artificial limbs, as well as some services such as physical therapy and hospice care. The plan would also reduce reimbursements to doctors by 15%.

Governor Davis' Budget Plan



The state's primary and secondary schools would receive about $2.2 billion less funding than last year, which would put a great deal of pressure on a number of already struggling school districts. Cal State University and University of California would have $700 million cut from state funding which would force student fees to rise.

Impact on Local Governments

The $8.3 billion in tax increases proposed by Davis would be paid to counties to take over certain health and social services ranging from children's programs to care for the mentally ill. Davis did not reintroduce the increase in vehicle license fees (VLFs) this fiscal year; however, his budget eliminates the payment that local governments had been receiving as compensation for the state's prior reductions in VLFs. The effect on local governments is a $1.3 billion hit in this fiscal year and $2.9 billion next year.

The credit pressure will heat up for all local governments to maintain targeted reserves. Schools will likely cut special programs, lay off teachers and increase classroom size. Los Angeles Unified School District already voted to increase the classroom size of some upper grade classes to 40 students.

Counties will struggle to provide additional health care and children services to low income and needy families despite the pledge of additional funds to cover expenses. The problems will erupt when tax revenues grow slower than expenditures and counties will be called upon to make do. Although the likelihood of non-payment of municipal bonds is remote, the credit pressure resulting from the state's budget problems will likely result in some rating downgrades as issuers struggle to maintain reasonable levels of operations with fewer resources.

What's on the Table?

Critics of Davis' proposal suggest that the plan should expand rather than deepen the tax base. In other words, instead of increasing the sales tax, more "things" should be taxed. Prior to the budget announcement, Democrats talked about levying taxes on a number of services including the fees of lawyers, accountants, doctors, auto repairs and dry-cleaning, to name a few. Democratic legislators also discussed restructuring Proposition 13 (25-year old legislation limiting property tax increases) to exclude commercial property from the tax limits. Republicans, however, prefer to place a constitutional cap on spending rather than raise taxes.

Governor Davis believes that creating more jobs can jumpstart the economy. One way to achieve this would be to accelerate the issuance of $21 billion in authorized yet unissued bonds for new roads, schools and housing. It's a bit ironic to cut spending for transportation, education and housing while issuing bonds to support those sectors. Bond financing, however, spreads the costs over decades and reduces the current pain of the cuts. The state is also considering the issuance of pension bonds to cover $1.5 billion owed to retirement funds for state teachers and other employees.

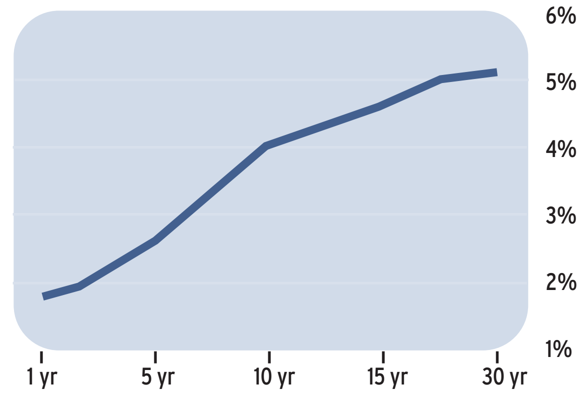
No single solution will close the state's mammoth deficit. In hindsight, the state was overly optimistic in assuming that the remarkable growth in revenues could be sustained year after year. Rather than looking forward with skepticism, particularly after the technology bust and the events of September 11, California officials continued to maintain high levels of expenditures. Now California legislators must address the state's seemingly intractable gap with realisitic projections, foresight and flexibility.

California marketplace

California State General Obligation Yields

Maturity	Yield	Quarterly Change	YTD Change
1-year	1.85%	0.45%	+0.00%
2-year	1.90%	0.40%	-0.60%
5-year	2.85%	0.45%	-0.85%
10-year	4.05%	0.62%	-0.60%
15-year	4.60%	0.50%	-0.47%
20-year	5.02%	0.48%	-0.19%
30-year	5.16%	0.37%	-0.14%

Source: MMD as of 12/31/02



State Yield Spreads

(yield differential between California and general market AAA yields)

Maturity	12/31/02	12/31/01	12/31/00
5-year	+0.50%	+0.12%	-0.15%
10-year	+0.52%	+0.21%	-0.15%
15-year	+0.48%	+0.16%	-0.16%
30-year	+0.43%	+0.06%	+0.06%

Source: MMD

Selected California Stocks

As of 12/31/02

Name	Ticker	Price	YTD Return
AMGEN	AMGN	48.34	-14.35%
Cisco Systems	CSCO	13.10	-27.66%
The Walt Disney Co.	DIS	16.31	-21.28%
Wells Fargo	WFC	46.87	+7.82%
Yahoo!	YHOO	16.35	-7.84%

Source: Bloomberg

issuance corner

California issuance year-to-date $49 billion
California 30-day visible supply $601 million

RECENT DEALS

$3 billion	Golden State Tobacco Securitization
$396 million	San Francisco Public Utilities Commission
$156 million	San Francisco Airport

UPCOMING ISSUES

$200 million	San Diego Sewer Revenue
$290 million	Southern California Public Power
$367 million	Los Angeles Wastewater

PAYDEN & RYGEL CALIFORNIA MUNICIPAL MARKET BAROMETER

The Payden & Rygel California Municipal Market Barometer is a composite of nineteen frequently traded California issues. The issues were chosen to represent the intermediate California marketplace. The bonds are all rated "A" or higher, and are not subject to the alternative minimum tax.

CHARACTERISTICS

Average coupon	5.23%
Average yield to maturity	2.95%
Average duration	4.63 years
Effective maturity	7.24 years

PERFORMANCE 2002

	Income	Price	Total Return
4th Qtr 2002	0.68%	-1.36%	-0.68%
Year-to-date	3.59%	4.71%	8.30%

The Impact of United Bankruptcy on LAX and SFO

While airline bankruptcy is never good news for airports, Los Angeles and San Francisco airports seem poised to weather United Airlines' bankruptcy fairly well. After UAL Corporation, the parent company of United Airlines, filed for Chapter 11 bankruptcy reorganization on December 9, 2002, CEO Glenn Tilton affirmed that United would maintain its strong presence in California even if some unprofitable routes were dropped. As the largest operator at both Los Angeles and San Francisco airports, United views the West Coast as integral to its recovery strategy.

Commitment to California

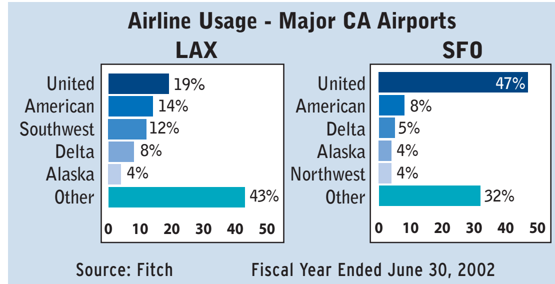
According to CEO Tilton, "The West Coast is a real core strength for United and obviously our window to the Pacific." In fact, more than 25% of United's approximately 1,800 daily departures originate in California, and 27% of United's employees are based in the state. During reorganization, United will likely consider the long-term benefits of holding on to these strategic gates.

The Runway to Bankruptcy

United's fall from its height of power and profitability was quick; over the past two years, employee morale and customer service levels dropped while losses grew to record levels. Diminished airline travel post-September 11 further highlighted the incongruity of the airline's high operating costs and falling fare revenue. With fewer passengers and declining fares, United cut flights by 40% but continued to pay high labor rates. As a result of such high fixed expenses, United was second only to US Airways (which also filed for Chapter 11) in highest operating expenses per available seat mile in the second quarter of 2002. After the Federal government rejected United's early-December request for a $1.8 billion loan guarantee, the carrier was unable to make scheduled payments on its $21 billion of debt and the largest airline bankruptcy in history became inevitable.

Relationships with Airports

United is the largest carrier at both Los Angeles and San Francisco airports. These airports serve large population bases and have a high percentage of origination and destination traffic, 67% for Los Angeles and 77% for San Francisco. Should United cut back on flights or gate leases, other airlines, such as Southwest, stand ready to expand into these slots.



There are two types of agreements under which airlines operate with airports: residual and compensatory. San Francisco Airport operates under a residual ratemaking methodology, whereby airline landing fees can be increased to compensate for revenue shortfalls. Since this methodology allows recovery of expenses from other airlines should one airline stop paying, revenues generated under the residual methodology are relatively secure. Los Angeles Airport operates under a compensatory, or cost-based, ratemaking methodology whereby rates such as landing fees are set at reasonable, cost-recovery levels. The ability to adjust landing fees in this case is limited, but over time Los Angeles has generated a large unrestricted reserve fund by charging airlines reasonable rates above cost. In a case of declining revenue, Los Angeles can tap into this fund as needed.

Road to Recovery

United expects to emerge from reorganization in 18 months, and senior management has made it clear that major changes will be implemented to ensure a successful recovery. Labor costs will drop with the recently announced wage cuts of 29% for pilots, 9% for flight attendants and an average of 11% for senior managers as well as the elimination of at least 1,688 jobs. Industry experts also expect cutbacks in routes and services, overhauls to hub airport operations and even route or asset sales to raise cash. Since revenues are not forecasted to improve in the near future, United will have to drastically reduce costs, change business practices and increase labor efficiency to revert to its profitable status.