

The State of California's Bonds

California's economic and political woes have driven credit ratings on its General Obligation (G.O.) bonds to the lowest levels in the state's history. Investors' fear of default has driven prices down and yields up. Is the yield worth the risk?

Our analysis indicates:

- A unique combination of economic and political factors has afflicted California.
- In the short term, concerns over the state's liquidity through fiscal 2004 are real.
- In the long run, California's powerful economic engine is primed for accelerated growth as the national and global economies recover.
- We are underweighting California G.O.s today.
- If the liquidity issue can be resolved and/or credit spreads widen significantly, we'd expect to increase our weighting.

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**Significant Research
Conclusions**

California has been in the throes of the worst fiscal and political crisis in its history, and has the dubious distinction of having the worst credit rating among all the states in the nation. Stalled economic growth, chronic budget deficits, a legislature unable to compromise, and a divisive recall election have combined to raise investor concerns over the possibility of default.

We expect no easy and immediate solutions to the state's current problems. But we also believe that the likelihood of default on its General Obligation (G.O.) bonds is extremely remote.

While California's recent history makes its future prospects appear uncertain, our research leads us to conclude that the state's fundamental economic strength, the general economic recovery, and modest steps to balance its budget will result in a higher degree of fiscal stability.

Once liquidity is secured to pay off maturing obligations due at the end of June 2004, we believe the state's fiscal health should begin to improve. We don't expect California to reclaim the triple-A rating it enjoyed in the late 1980s and early 1990s and, in fact, don't expect the rating agencies to upgrade California's G.O. bonds to the double-A level for quite a few years.

In the meantime, we recognize that short-term risks to the state's liquidity remain through fiscal 2004, and have responded with a more conservative investment approach.

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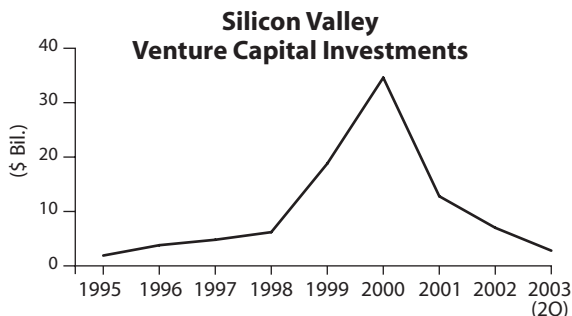
HOW CALIFORNIA GOT INTO THE BIND IT'S IN

As longtime observers of California, we know that the roots of its current fiscal crisis are as big and complicated as the state itself. During the latter half of the 1990s, California, like most of the country, rode high on booming economic growth. But the “turbocharge” the state got from its concentration of tech industries meant it suffered more than others when the tech bubble burst. The resulting swift and severe loss in tax revenues went largely unaddressed by the state legislature. This lack of political responsiveness is not new: California government has for years failed to produce budgets that balance recurring revenues and spending. This chronic inability to act is due to the state’s longtime political acrimony, the latest evidence of which was the almost unprecedented gubernatorial recall.

The Bubble Fallout

Beginning in 2001, California companies began to suffer from dramatically lower levels of domestic and international demand, lower capacity utilization in the manufacturing sector, and growing expenses due to increases in energy costs and workers’ compensation premiums. Investment in the economic engine that was information technology in Silicon Valley dropped precipitously, from \$34.6 billion in 2000 to just \$7 billion in 2002, and the slowdown continued into 2003¹ (*Display 1*).

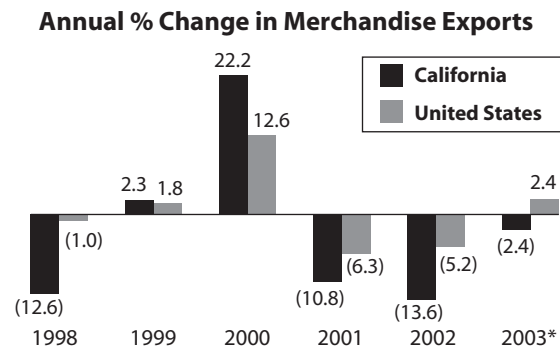
DISPLAY 1



Source: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association

As the global economy caught the economic cold of the U.S., California’s economy was further hurt by slowing merchandise exports—especially in computers and electronic equipment, which made up more than half its total shipments overseas. The value of products shipped abroad declined rapidly after 2000 (*Display 2*). Even as trade picked up for the nation, California exports continued to fall in 2003.²

DISPLAY 2



*2003 figures are year-to-date through August 2003
Source: Massachusetts Institute for Social and Economic Research

Job losses, concentrated in the high-tech industry, along with significant losses in corresponding stock-option income, caused the Golden State to lag the nation in personal income growth. In 2001 and 2002, personal income growth slowed dramatically to just 2.6%. This was the lowest rate of increase since the recession of the early 1990s.³ (The state’s compound annual growth rate for personal income has been approximately 8% since the 1950s.)

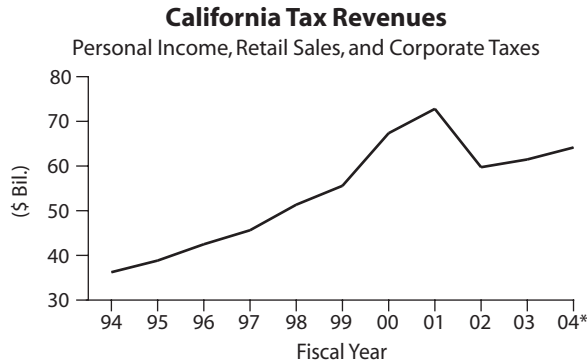
The sputtering economy and slowing personal income growth meant falling tax revenues, after years of steady increases (*Display 3, facing page*), with receipts from income, sales, and corporate taxes dropping from \$72.8 billion in fiscal 2001 to a \$61.5 billion in fiscal 2003. Capital gains and stock-option-related revenues took the hardest hits because of the inordinate revenue-generating concentration of tech-industry taxpayers. As a percent of total General Fund

1 MoneyTree™ Survey, PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association, Investments by Region Q1 1995–Q2 2003.

2 Massachusetts Institute for Social and Economic Research

3 U.S. Department of Commerce, Bureau of Economic Analysis, September 23, 2002. Estimate for 2002 provided by the California Department of Finance.

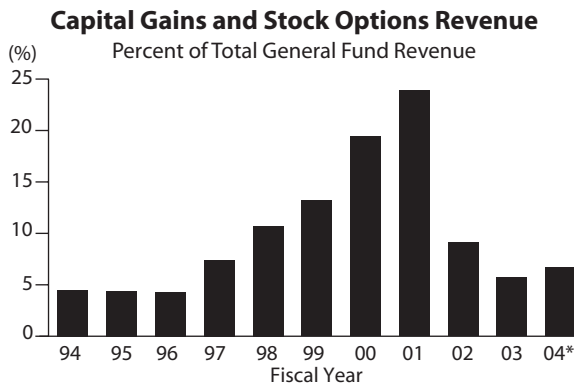
DISPLAY 3



Note: 03 is revised
 *Forecast based on enacted fiscal 2004 budget
 Source: California Department of Finance and Legislative Analysts Office

revenue, the combination of capital gains and stock option revenues fell from close to 25% in fiscal 2001 to an estimated 7% in fiscal 2004⁴ (Display 4).

DISPLAY 4



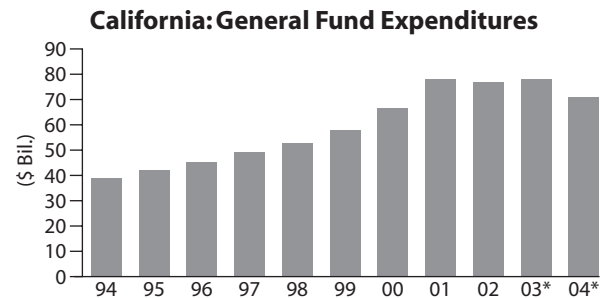
Note: 03 is revised
 *Forecast based on enacted fiscal 2004 budget
 Source: California Department of Finance and Legislative Analysts Office

Budget Distress

Certainly, the magnitude and speed with which the state’s personal income revenues declined were extreme, but the governor and legislature failed to curb spending. Expenditures that had risen steadily through the 1990s peaked in fiscal 2001 at about \$78 billion and remained close to that level through fiscal 2003 (Display 5). But in fiscal 2003, the state had \$12.3 billion less in stock-option and capital-gains-related revenues to address the same level of expenditures. This sharp decline in revenues, coupled

with spending and tax relief left over from a different era—that of the tech boom—produced a projected budget shortfall for the state’s General Fund of \$26.1 billion for fiscal 2004 alone. While the budget crisis was felt nationwide, California’s situation was the most acute: Its share of the total projected nationwide shortfall in fiscal 2004 was an extraordinary 33%.⁵

DISPLAY 5



Note: 03 is revised and 04 is based on enacted fiscal 2004 budget
 *Forecast
 Source: California Department of Finance and Legislative Analysts Office

The 2003–04 Budget Act signed in August 2003 was a step toward some sense of fiscal stability. However, the adopted spending plan included about \$15 billion in deficit financing and did not fully address the state’s long-term structural imbalance. The Department of Finance and the Legislative Analysts Office each anticipate an \$8 billion deficit for fiscal 2005, foreshadowing another contentious legislative session to come.

While the remaining deficit is troubling, we believe it would have been unrealistic and economically counterproductive to close such a huge deficit in just one year. And though the plan may be too reliant on borrowing, this budget was probably the best deal the state could muster, given the political gamesmanship, growing partisanship, and, at that time, the on-going campaign to unseat the sitting governor. Additionally, its relatively quick adoption meant the state avoided an immediate cash “crunch” in October 2003.

⁴ California Department of Finance and Legislative Analysts Office

⁵ National Conference of State Legislators

The recent promise by the new governor-elect to repeal the Motor Vehicle Licensing Fee (MVLFF) increase throws even this delicate balance into question. The MVLFF generates \$4 billion per year for California. Repealing it without offsetting actions would only deepen the state's fiscal problems.

Political Dysfunction

Economic factors beyond the state's control set the wheels of financial distress in motion, but the lack of response to it was due to a dysfunctional political environment. First, California has long required a high degree of bipartisanship to pass key financial actions: The state is one of only three that require at least a two-thirds supermajority to pass a budget, and one of only seven that require at least a two-thirds legislative approval to raise taxes.⁶ As evidence of the problems this creates, 12 of the last 15 budgets were adopted after the beginning of the new fiscal year.

Budget talks became increasingly difficult after Democrats lost seats in both the state Assembly and Senate during the November 2002 elections. Though the Democrats were still in the majority, they were even further away from the votes needed to pass a budget. With Democrats and Republicans deeply divided over whether to raise taxes or reduce spending, fundamental resolution of the state's structural budget deficit has been thwarted by political deadlock.

The debate over raising taxes versus reducing spending has become highly charged. According to a recent Los Angeles *Times* article, "In a closed-door joint Senate and Assembly GOP caucus meeting, Senate Republican Leader Jim Brulte of Rancho Cucamonga . . . told colleagues that he will come to their districts and seek their defeats in their next elections if they vote for tax hikes."⁷ Another article stated that during a Democratic

Study Group meeting, "Los Angeles Assemblywoman Jackie Goldberg and others discussed holding up the budget to dramatize the consequences and build support for a ballot initiative that would make it easier to raise taxes."⁸ Such stories and statements are indicative of a highly divided legislature and further contribute to undermining credit quality.

And, of course, the recent recall campaign served to widen the political rift between state Republicans and Democrats. The fact that there is a new occupant in the governor's mansion doesn't necessarily mean the political intransigence will come to an end. But whether state politicians, jolted by the shock of the recall and its outcome, will be more inclined to compromise and work with the governor-elect to address the state's fiscal and credit crises remains to be seen.

Limited Budget Discretion Hampers Prospects

Our analysis shows that the 2003–04 budget faces challenges beyond simply the ones inherent in its construction. A wide array of voter initiatives have either earmarked revenues for specific purposes or have placed restrictions on the ability of government to raise revenues. This initiative process has diminished the revenue-raising flexibility of both state and local governments, has undermined credit quality, and ultimately has put a ceiling on the rating of California's G.O. bonds.

At the state level, the most obvious example of this is Proposition 98, which mandates that K–12 education receive approximately 40% of state General Fund revenues⁹ (*Display 6, facing page*). Proposition 98 permits the legislature to suspend the formula but only with a two-thirds vote and the governor's agreement. At the local level, Proposition 13, which limits property tax

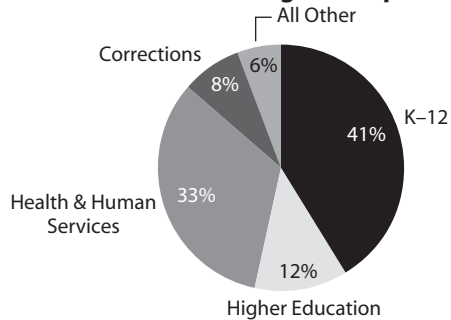
⁶ *The Council of State Governments; the National Association of State Budget Officers, "Budgetary Processes in the States, 1999"; and the National Conference of State Legislatures. Florida requires a two-thirds legislative approval for an increase in corporate income taxes.*

⁷ Evan Halper, "Careers at Stake, Brulte Tells GOP"; *Los Angeles Times*; Jun 5, 2003; pg. B.1

⁸ Evan Halper and Nancy Vogel, "Democrats Discussed Extending Budget Crisis"; *Los Angeles Times*; Jul 22, 2003; pg. A.1

⁹ Known officially as the Classroom Instructional Improvement and Accountability Act, Proposition 98 was passed in 1988 and amended by Proposition 131 in 1990.

DISPLAY 6

California FY04 Budgeted Expenditures

Source: California Department of Finance

collections to 1% of assessed valuation, also negatively impacts state operations. Local governments, prohibited from tapping this more secure, less volatile revenue source, look to the state to assume the responsibility for funding certain ongoing operations. That adds to the state's already heavy spending obligations.

Health and human services make up another 33% of fiscal 2004 state expenditures. Medicaid outlays in California (known as MediCal) are one of the favorite targets for proposed spending reductions. Many seem to believe that MediCal expenditures have been increasing at an exponential clip: As of federal fiscal year-end 2000, California ranked second among all states in nominal Medicaid spending. However, from a cost-per-beneficiary perspective, California Medicaid-related outlays were just 55% of the U.S. average.¹⁰ It may be easy politically to call for cuts in this large expenditure category, but the state is mandated by the federal government to fund a minimum level of service, and cutting back to that "minimum" would reduce federal reimbursement, making any cuts especially painful.

Another area of the budget that is hard to cut is corrections, which makes up 8% of fiscal 2004 General Fund expenditures. With the 1994 passage of the "three strikes and you're out" ballot initiative, more inmates face life in prison, and taxpayers are shouldering the burden of care for those prisoners, which should become increasingly costly as the prison population ages.

The Result: Ratings Downgrades

In response to California's political and fiscal troubles, rating agencies cut their credit assessments of the state's General Obligation bonds to the lowest levels in its history. Downgrades over the past several years have lowered the state's rating from the AA-level to A3 at Moody's and BBB at Standard & Poor's. Only two other states have been rated as low as BBB since 1960: Massachusetts in the early 1990s and Alaska in the 1960s.¹¹ Investors, equating the lower ratings with a higher risk of default, have shunned California's existing bonds, driving their prices down. To overcome investor reticence about its new bonds, California has been forced to offer them at higher yields.

THE INVESTMENT QUESTION

Do California G.O. bonds represent an investment opportunity today? In other words, are the high yields being offered worth the risks? In part, the answer rests on whether, in the long run, the state's economy will improve, thus generating much-needed additional tax revenues. Based on our research, we believe the California economy is well positioned for growth. But in the near term, budget issues that are closely linked to politics may pose a threat to the state's liquidity. California has both the ability and authority to resolve its financial problems. But, do its leaders have the political willingness? Clearly, California's credit problems are affected by short- and long-term influences.

THE SHORT-TERM LIQUIDITY RISK

The most immediate and pressing issue for the state is its ability to repay short-term cash flow notes that mature at the end of fiscal 2004. It is standard practice for states to borrow funds on a short-term basis to smooth revenue receipts over a given fiscal year. California is no exception, though its cash needs are far larger than most. The state borrowed \$11 billion by issuing Revenue Anticipation Warrants (RAWs) in June 2003 to enable it to pay bills and

¹⁰ Centers for Medicare and Medicaid Services

¹¹ Michigan, Louisiana, and Delaware were rated BBB+ or Baa1.

replenish cash balances. Proceeds of this sale went to retire outstanding Revenue Anticipation Notes (RANs, unlike RAWs, have to be paid back the same year), as well as to provide an additional cash cushion for the beginning of the current fiscal year. The state recently completed another RAN sale of \$3 billion. As a result, the liquidity to meet daily operations has been secured until June 2004, at which time the state must repay investors \$14 billion to retire the \$11 billion issuance of RAWs and \$3 billion issuance of RANs.

The fiscal 2004 budget accounts for this \$14 billion in payments, but relies on the sale of \$10.7 billion of fiscal recovery bonds. Proceeds of these bonds would be available to repay the maturing short-term notes. Absent these funds, the state will have insufficient cash on hand to pay off its short-term obligations.

Whether the proposed fiscal recovery bonds will actually be issued is in question. First, they have been challenged on state constitutional grounds.¹² Second, given the recent recall, the governor-elect faces a highly abbreviated time frame in which to decide whether his administration will defend the challenge or devise some other means of furnishing the needed liquidity to meet fiscal 2004 cash flow obligations. The governor-elect has recently suggested seeking voter approval of the respective bonds through a March 2004 referendum. If voters reject the bond measure, or if the legal challenge succeeds, the state will be forced to choose between quickly adopting a contingency plan—not easy in the midst of a divided political system—or failure to pay its short-term obligations.

It is difficult to say with any degree of certainty what form the ultimate short-term liquidity “solution” will assume. The greatest challenge to resolving the liquidity question is the speed with

which it needs to be resolved; speedy decisions, however, are not assured given the political environment in California. On balance, we remain confident that the state will take prudent steps to meet its obligations and maintain market access to sell future bonds, as the cost of failure is operationally and financially debilitating: “Normal” operation of state government would be significantly hampered and borrowing costs would rise sharply.

THE LONG-TERM PROSPECTS

Over a longer time horizon, California’s underlying credit strength will be largely determined by two factors: 1) politics and 2) the economy. Simply stated, there are only three ways to cure a state’s structural operating deficit: raise taxes, cut expenditures, or some combination of the two. But these choices are made abundantly more complex when the politics of decision-making is introduced. A state’s legislature must be politically willing to come to some compromise to align receipts with expenditures. As discussed, this willingness has been virtually nonexistent in California of late, detracting from the art of compromise and leading to legislative paralysis.

But as much as politics has detracted from credit quality, California’s fortunes will ultimately be driven by its economy. And California’s powerful economic engine remains intact.

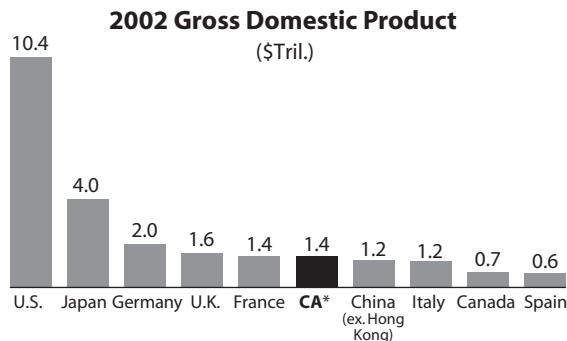
There is no other state economy with California’s depth and breadth, and it’s primed to grow at an accelerated pace, which will contribute greatly to improving California’s fiscal health and credit strength. Though the state currently finds itself in a true fiscal and political dilemma, our research has identified several basic factors that will drive future economic growth. Indeed, some of these factors are simply positive news that has been overlooked amid all the negativity.

¹² Both the state’s bond counsel and its attorney general have opined that the fiscal recovery bonds are not debt as defined under the California constitution.

Solid Economic Infrastructure

California's economy is the sixth largest in the world (*Display 7*). Moreover, it is extraordinarily diverse. The state is a popular destination for both international and domestic tourists. It feeds the world with a vast array of agricultural products. It exports high-technology goods and services. It develops ideas for new technological breakthroughs. It is a global center of entertainment media. It is a crucial point of entry for a large portion of imported goods. And it retains a substantial aerospace sector that will continue to benefit from increased defense spending.

DISPLAY 7



*California figure is from the UCLA Anderson Forecast, June 2003
Source: World Bank: World Development Indicators database, July 2003

Furthermore, a unique array of factors support California's economy: a generally educated workforce, a strong public university system, and arguably some of the country's best private universities, all of which create a climate of entrepreneurship; and a very strong track record of securing venture capital. In fact, while venture capital investment has dropped off in absolute terms, it has remained at its historical level of 40% of total national investment.¹³ And the level of new business incorporations remains at historically high levels as well.¹⁴ Thus, we believe the state's economic infrastructure remains strong and poised for consistent growth as the nation's economy gathers speed.

Foreign Trade Should Pick Up

California was hit particularly hard by the global recession, so the state should benefit in kind when global economic and business expansion strengthens. The falling U.S. dollar should boost trade. And while recent geopolitical uncertainty and random anomalies like the SARS epidemic have muted this impact, a more normal relationship between a falling dollar and improved trade should return. We expect California's foreign trade to grow both on a nominal basis and as a percent of total national exports (*Display 8*). We recently revised growth estimates significantly upward for Japan and the rest of Asia and, given California's reliance on these countries as trading partners, we believe such potential growth bodes well for the state. Furthermore, California's proximity to Mexico, its number-one trading partner, is a comparative advantage.

DISPLAY 8

Percent Change in Exports to California's Top Ten Export Markets

	2001	2002	% change 2001-2002
Mexico	\$16.3	\$16.1	(1.6)%
Japan	14.6	11.1	(24.1)
Canada	11.8	10.1	(14.7)
China (Taiwan)	5.7	5.4	(4.8)
South Korea	5.0	4.7	(6.4)
China (Mainland)	4.7	4.5	(4.1)
United Kingdom	5.6	4.3	(22.2)
Hong Kong	3.9	3.7	(6.4)
Netherlands	4.3	3.6	(17.2)
Germany	4.7	3.5	(25.3)
Other	30.1	25.3	(16.0)

Source: Massachusetts Institute for Social and Economic Research.

Employment Starts From a Relatively Strong Position

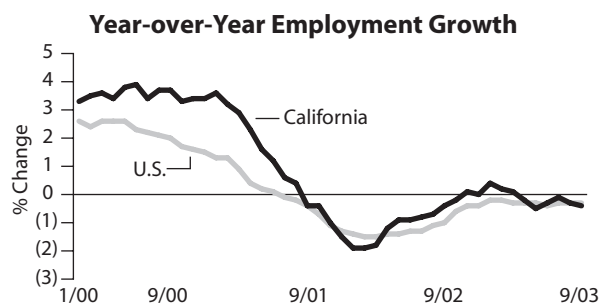
California's jobs picture is actually better, relative to other states', than the numbers might indicate. According to the Bureau of Labor Statistics, California's unemployment rate increased to 6.4% in September 2003 from a low of 4.7% in February 2001, but the state actually outper-

¹³ MoneyTree™ Survey, PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association, Investments by Region Q1 1995-Q2 2003.

¹⁴ "California Economic Indicators"; California Department of Finance; May-June 2003; pg. 16

formed the nation from a “jobs” perspective over much of the past three years (*Display 9*). In other words, the unemployment problem in California is no worse than in most other states, and in some ways better. Since January 2000, the number of non-farm jobs in the state increased 1.5%, significantly outperforming the national total, which was basically stagnant. In the important computer and electronic-product manufacturing sector, while California lost one-fifth of its jobs between May 2000 and May 2003, this was actually less than the nation as a whole.¹⁵ Between 1990 and 2003, the ratio of high-tech manufacturing jobs in California relative to the nation has actually remained constant.¹⁶

DISPLAY 9



Source: Bureau of Labor Statistics (non-farm, seasonally-adjusted employment) and California Employment Development Department

Additionally, the precipitous drop in jobs through September of 2003 was still roughly just 60% of the job losses that occurred in the recession of the early 1990s when large defense and aerospace-

related industries in Southern California were dismantled. This data indicates a potential strengthening in the net domestic migration into the state (people tend to follow jobs) and a corresponding increase in gross state product (and thus tax revenues) over the near-term. Indeed, consensus forecasts from various consulting, economic, and government services project year-over-year improvement in the pace of non-farm employment for 2003 and 2004 (*Display 10, columns one and two*).¹⁷

Personal Income Will Likely Rebound

If the economy picks up and jobs grow as we expect, personal income will rebound as well. That expectation is also reflected in consensus forecasts (*Display 10, columns three and four*).¹⁸

While these rates of growth are not explosive, their effect should be multiplied by California's tax-rate structure. The progressive nature of the state's income-tax rates, with top wage earners paying higher taxes when they make more money, means California tax revenues are highly sensitive to changes in personal income. Studies have shown that they are 3.5 times more sensitive than the national average.¹⁹ As we look to the future, this means that improvements to personal income will disproportionately benefit California's tax revenues. Given that over 90% of the state's General Fund revenues are derived

DISPLAY 10

California Economic Forecasts: Annual % Change

	Wage & Salary Employment		Current Personal Income	
	2003 vs. 2002	2004 vs. 2003	2003 vs. 2002	2004 vs. 2003
Western Blue Chip (October 2003)	0.5%	1.7%	3.3%	1.6%
Legislative Analysts Office (October 2003)	0.5	2.4	4.0	6.1
UCLA—Business Forecasting Project (September 2003)	(0.3)	1.0	3.2	3.9
Wells Fargo & Co. (September 2003)	0.3	1.4	3.5	4.2
California Department of Finance (April 2003)	0.6	2.1	3.1	4.9
Consensus Forecast	0.3%	1.7%	3.4%	4.7%

15 Stephen Levy, “California and Texas Job Growth: Surprising Results”; Center for Continuing Study of the California Economy; pg. 1

16 Stephen Levy, “Center Releases Economic Outlook Report”; Center for Continuing Study of the California Economy; pg. 3

17 Average of California Department of Finance, Legislative Analysts Office, UCLA, Western Blue Chip, and Wells Fargo Economics

18 Ibid.

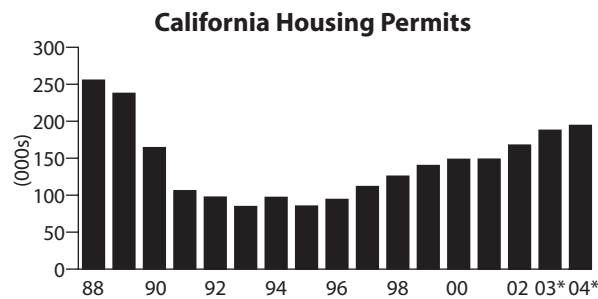
19 “California Outlook”; Wells Fargo Economics; July 2003; pg. 1

from personal income (including stock options and capital gains), sales, and corporate taxes, we expect that California's fiscal recovery will be stronger than most states'.²⁰

Housing Should Remain Strong

California's housing construction industry is an increasingly important sector within the state's economy. Significantly, the sector has maintained consistent strength through boom and bust, just as it has across the country. Overall, California housing permits have increased each year since 1995, growing about 10% annually (*Display 11*).

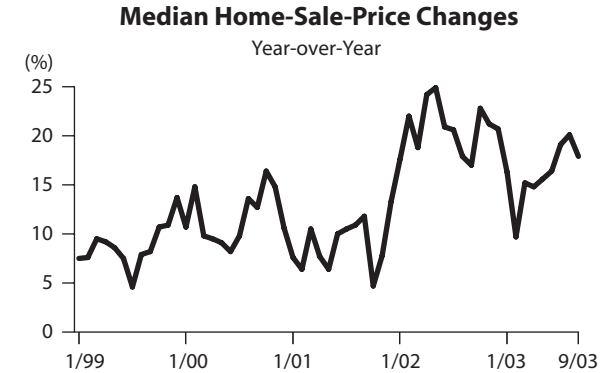
DISPLAY 11



Although existing home sales declined almost 25% through 2001 from their peak in 1999, they recovered in 2002.²¹ Record low mortgage rates boosted sales over 12% in 2002—a level surpassed only three times since 1985. Median home-sale prices saw record highs being recorded in virtually every passing month. The September 2003 preliminary median home price was 18% greater than for the same month in 2002 (*Display 12*).

Housing prices and overall sales are highest and most consistent in Los Angeles, a reflection of greater local job creation. This is in stark contrast to the previous recession in the early 1990s, during which the Los Angeles/southern region was hit harder than its northern counterparts, due to the significant contraction in the defense/aerospace-related sectors.

DISPLAY 12



The only negative we see is nonresidential real-estate construction, which suffered in the latest downturn. After hitting a high of \$18.6 billion in 2000, total nonresidential building permit valuations have declined precipitously as business investment in industrial, office, and general mercantile/store construction continues to fade. Along with the decline in nonresidential construction came a dramatic increase in metro-area office vacancy rates. As the business environment improves over the midterm, we expect the overhang of available space (particularly in the north) to be gradually absorbed.

Finally, we are aware that many suspect that the strength in the housing sector is simply a price bubble. But our research shows that California's unsold inventory index and the median time that housing remains on the market are at or near historic lows.²² We see an ongoing shortage of available housing and, given anticipated population increases, we don't envision a sharp shift in the state's supply/demand dynamics.

Risk To the Forecast

As with any forecast, there are several potential risks to these projections of economic growth, including the shift in high-tech production from California to Asia, as well as regulatory issues, which could hamper future business creation and relocation. Factors of concern

²⁰ General Fund is the state's primary operating fund

²¹ California Association of Realtors

²² Ibid.

include: 1) the high cost of mandatory workers' compensation insurance; 2) continued high electricity rates stemming from the "energy crisis" of 2000 and 2001; 3) the state's minimum wage, which is 31% higher than the federal level; 4) lack of affordable housing; and 5) recently signed legislation requiring businesses with more than 20 employees to finance medical coverage for all workers and some dependents. Nevertheless, while any of these risks might mute the economic recovery, we don't believe they will derail it.

California's Debt Position Has Room to Grow

Despite the significant amount of government-obligation debt²³ added since fiscal 1998, we believe the state's debt ratios are moderate. According to Moody's Investors Service, net tax-supported debt per capita and net tax-supported debt as a percent of personal income was \$810 (19th among all 50 states) and 2.5% (23rd among all states), respectively. Note that the higher the rank, the higher the debt ratio—thus, these numbers were actually an improvement over medians released in 1998 (*Display 13*). If we add the anticipated tax-supported issuance for fiscal 2004 (an unprecedented \$20.2 billion, of which \$5.2 billion is for capital construction) to the state's balance sheet, holding all other things constant, the state would move up to rank

seventh by both measures. It's significant to note that all states in the top 10 of outstanding debt per capita and debt as a percent of personal income—with the exception of New York—have ratings in the double-A category or better.

On a comparative basis, California has excess debt capacity that can be filled without additional threats to its current credit assessment.

OUR INVESTMENT CONCLUSIONS

Investors' concerns about California's finances are reflected in higher credit spreads²⁴ (*Display 14, facing page*). As California's credit has weakened, particularly toward the end of July 2003, credit spreads widened (and prices fell). In other words, investors demanded more yield for a California G.O. bond than a generic municipal triple-A-rated bond. During the week in which the state senate adopted a budget, the spread on 10-year California G.O. bonds widened to 95 basis points above a triple-A municipal. During the week following the S&P downgrade and the period in which the state assembly affirmed and passed the senate's budget bill, spreads narrowed to 70 basis points. As of October 23, 2003, they had further narrowed to 50 basis points. Still, by historical standards, the extra yield available for California G.O.s is high. And by that measure, the bonds are attractively priced, particularly for investors

DISPLAY 13

California's Relative Credit Position

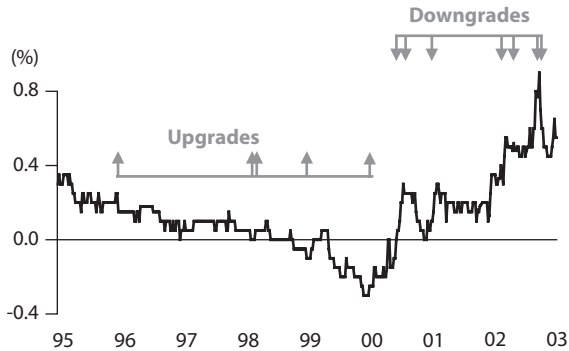
	1998			2003		
	California	States Median	California/U.S.	California	States Median	California/U.S.
Debt Per Capita	\$652	\$446	146%	\$810	\$606	134%
Rank	15th	—	—	19th	—	—
Net Tax-Supported Debt as % of Personal Income	2.6%	1.9%	137%	2.5%	2.2%	114%
Rank	20th	—	—	23rd	—	—

Note: 2003 data is based on 2002 population estimate and 2001 personal-income figures; 1998 data is based on 1997 estimated population and 1996 personal-income figures. Source: Moody's Investors Service

²³ Non-selfliquidating

²⁴ Incremental yield (i.e., the spread) of California G.O. bonds vs. triple-A bonds. Three years ago such bonds were selling at a spread of minus-30 basis points (i.e., if a triple-A bond offered a yield of 4.0%, California G.O. bonds offered 3.7%). Today the spread is plus-50 basis points (i.e., in the same example, the California bond would offer 4.5%).

DISPLAY 14

Yield Spread: California G.O. vs. National AAA

Through November 7, 2003
 Source: Bernstein estimates for 10-year par bonds

such as ourselves who have a positive long-term outlook for the state's credit. But short-term risks linger.

Since the recall election, the investment outlook has become very fluid—definitive information concerning the governor-elect's fiscal plan has been sparse. We do know that he has said he intends to repeal the increase in the Motor Vehicle License Fee and that he is considering seeking voter approval for the fiscal recovery bonds. But the lack of clarity surrounding near-term action, and the increased risk it entails, are grounds for concern.

So, do California G.O.s represent value today? Are the high yields being offered worth the risks?

Though the probability of default is remote, credit and spread volatility remain. And the payoffs from the potential outcomes are

asymmetric. In the most likely outcome, we would expect spreads to narrow 10–20 basis points from current levels once the state is able to meet its short-term obligations due in June. The limited upside reflects the fact that the state still faces a significant structural imbalance that will require tough decisions going forward. However, in the unlikely event that the liquidity crisis occurs, we'd expect credit spreads to jump dramatically, as much as 100 to 200 basis points more. Time and again, investors have shown that they are risk averse—they are far more sensitive to losses than gains. This is particularly true in a municipal bond portfolio, which assumes the primary role of safety in an investor's asset allocation. Thus, we are underweighting California G.O.s at current spread levels. California G.O.s currently amount to 5% and 1% of our California and nationally diversified portfolios, respectively. Our neutral positions are 7% and 2%.

However, longer-term, if spreads widen significantly and/or short-term risks abate, we'd look to increase our California G.O. exposure to no more than 10% of our California portfolios and 5% of our nationally diversified portfolios, reflecting our positive outlook on California's long-term economic prospects. ■

Appendix

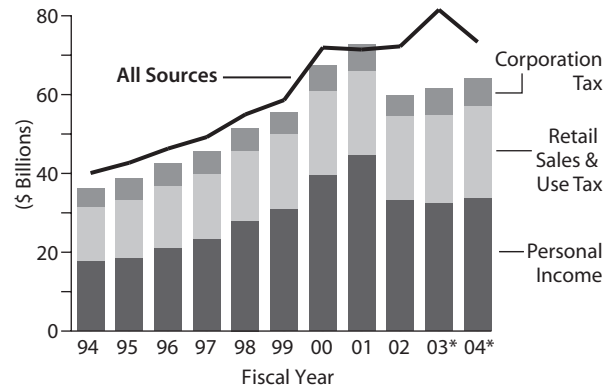
DISPLAY 15

History of California's General Obligation Bond Rating

Date	S&P	Date	Moody's
May 68	AAA	Aug 67	Aaa
Jan 80	AA+	Apr 80	Aa
Jan 83	AA	Oct 89	Aaa
Feb 85	AA+	Feb 92	Aa1
Jul 86	AAA	Jul 92	Aa
Dec 91	AA	Jul 94	A1
Jul 92	A+	Oct 98	Aa3
Jul 94	A	Sep 00	Aa2
Jun 96	A+	May 01	Aa3
Aug 99	AA-	Nov 01	A1
Sep 00	AA	Feb 03	A2
Apr 01	A+	Jun 03	A2 Negative Outlook
Dec 02	A	Jul 03	A2 Watchlist Negative
Jun 03	A Credit Watch Negative	Aug 03	A3 Watchlist Negative
Jul 03	BBB	Sep 03	A3 Negative Outlook

DISPLAY 16

California's Major Tax Revenues



*2003 figure is revised and 2004 is based on enacted fiscal 2004 budget
Source: California Department of Finance and Legislative Analysts Office

DISPLAY 17

California Merchandise Exports

(\$ Billions)

	1997	1998	1999	2000	2001	2002	2002 August (YTD)	2003 August (YTD)	CAGR* (1997-2002)	CAGR* (2000-2002)
California Exports	\$99.2	\$95.8	\$97.9	\$119.6	\$106.8	\$92.2	\$61.6	\$60.1	(1.4)%	(12.2)%
% Change		(12.6)%	2.3%	22.2%	(10.8)%	(13.6)%		(2.5)%		
U.S. Exports	\$687.6	\$680.5	\$692.8	\$780.4	\$731.0	\$693.3	\$458.9	\$469.7	0.2%	(5.8)%
% Change		(1.0)%	1.8%	12.6%	(6.3)%	(5.2)%		2.4%		
CA as % of U.S.	14.4%	14.1%	14.1%	15.3%	14.6%	13.3%	13.4%	12.8%		

* Compound annual growth rate
Source: Massachusetts Institute for Social and Economic Research

Appendix

DISPLAY 18

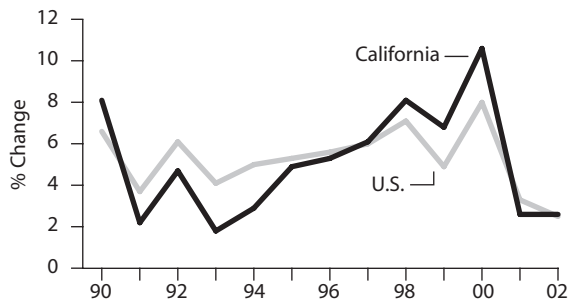
Regional Unemployment Rates Based on Annual Averages Since 1994

Region	1994	1995	1996	1997	1998	1999	2000	2001	2002
State of California	8.6%	7.8%	7.2%	6.3%	5.9%	5.2%	4.9%	5.4%	6.7%
Capital Region	7.1	6.7	6.0	5.4	4.9	4.1	4.1	4.1	5.2
Los Angeles Region	8.7	7.5	7.3	6.2	5.7	5.1	4.7	5.0	6.0
Los Angeles County	9.4	7.9	8.2	6.8	6.5	5.9	5.3	5.7	6.8
Rest of L.A. Region	7.6	6.9	6.0	5.3	4.6	4.0	3.9	4.1	5.1
San Diego County	7.0	6.4	5.3	4.2	3.5	3.1	3.0	3.2	4.3
San Francisco/Bay Area	6.0	5.5	4.5	3.8	3.5	3.0	2.5	4.1	6.5

Data not seasonally adjusted. Capital Region includes El Dorado, Placer, Sacramento, and Yolo Counties; Los Angeles Region includes Los Angeles, Orange, Riverside, San Bernardino, and Ventura Counties; Bay Area includes Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, Solano, and Sonoma Counties.
Source: California Employment Development Department

DISPLAY 19

Annual % Change in Personal Income



Source: U.S. Department of Commerce, Bureau of Economic Analysis

DISPLAY 20

Existing Home Sales

	No. of Units	% Change
1985	405,342	6.2%
1986	488,013	20.4
1987	511,600	4.8
1988	562,240	9.9
1989	538,120	(4.3)
1990	453,030	(15.8)
1991	424,810	(6.2)
1992	426,350	0.4
1993	435,010	2.0
1994	482,490	10.9
1995	425,640	(11.8)
1996	505,420	18.7
1997	555,380	9.9
1998	629,092	13.3
1999	659,378	4.8
2000	535,473	(18.8)
2001	508,479	(5.0)
2002	572,547	12.6
2003 (through Sept.)	631,880	10.4

Source: California Association of Realtors

Appendix

DISPLAY 21

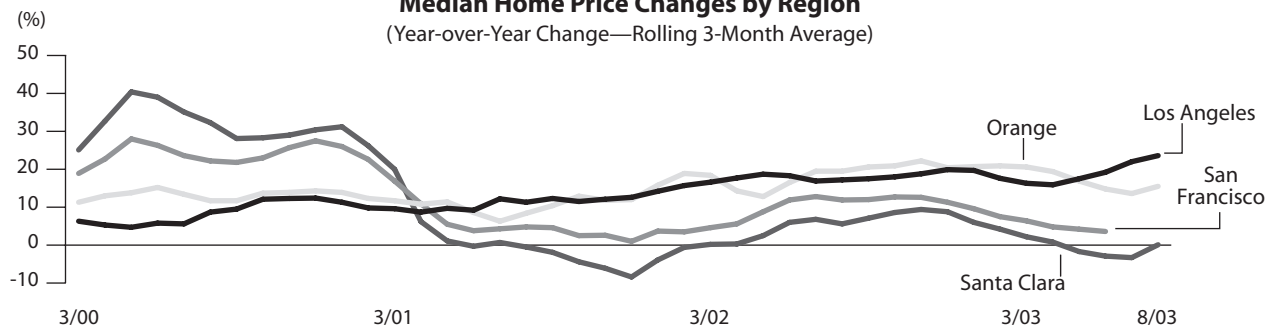
New Single- and Multi-Family Housing Permits by Region

	California		Los Angeles		Capital		San Diego		San Francisco/ Bay Area		Rest of California	
1988	255,559	0.9%	133,536	6.8%	18,741	10.3%	28,552	(7.7)%	37,785	4.7%	36,945	4.7%
1989	237,747	(7.0)	115,657	(13.4)	20,821	11.1	18,710	(34.5)	35,616	(5.7)	46,943	27.1
1990	164,313	(30.9)	68,476	(40.8)	16,546	(20.5)	15,796	(15.6)	21,976	(38.3)	41,519	(11.6)
1991	105,919	(35.5)	41,149	(39.9)	9,969	(39.7)	7,908	(49.9)	17,007	(22.6)	29,886	(28.0)
1992	97,407	(8.0)	35,014	(14.9)	9,071	(9.0)	6,059	(23.4)	15,878	(6.6)	31,385	5.0
1993	84,656	(13.1)	28,192	(19.5)	8,846	(2.5)	5,602	(7.5)	15,074	(5.1)	26,942	(14.2)
1994	97,047	14.6	35,745	26.8	9,697	9.6	6,935	23.8	17,490	16.0	27,174	0.9
1995	85,293	(12.1)	29,732	(16.8)	8,026	(17.2)	6,608	(4.7)	15,663	(10.4)	25,264	(7.0)
1996	94,283	10.5	33,680	13.3	9,001	12.1	6,868	3.9	21,709	38.6	23,025	(8.9)
1997	111,716	18.5	40,368	19.9	9,969	10.8	11,402	66.0	26,675	22.9	23,302	1.2
1998	125,707	12.5	43,581	8.0	14,791	48.4	12,173	6.8	28,547	7.0	26,615	14.2
1999	140,137	11.5	52,824	21.2	15,539	5.1	16,427	34.9	27,283	(4.4)	28,064	5.4
2000	148,540	6.0	55,399	4.9	16,907	8.8	15,927	(3.0)	28,652	5.0	31,655	12.8
2001	148,644	0.1	57,740	4.2	18,882	11.7	15,650	(1.7)	23,901	(16.6)	32,471	2.6
2002	164,110	10.4	66,970	16.0	22,920	21.4	14,234	(9.0)	21,635	(9.5)	38,351	18.1
2003 Forecast	187,800	14.4	—	—	—	—	—	—	—	—	—	—
2004 Forecast	194,400	3.5	—	—	—	—	—	—	—	—	—	—
2003 (first 9 months)	145,411		58,392		16,776		14,029		20,585		35,629	
2002 (first 9 months)	122,477		48,151		16,714		12,162		16,941		28,509	
Growth 2002–2003 YTD	18.7%		21.3%		0.4%		15.4%		21.5%		25.0%	

1/28/03 forecast for 2003 was 170,000 permits. Upped forecast 7/24/03 to 186,000 units. 2003 forecast increased again 10/24/03 to 187,800. 2004 estimate increased to 194,400. 2002 housing permit total was increased to 167,761 on 6/24/03.
Source: Construction Industry Research Board (1/28/03 and revised 10/24/03)

DISPLAY 22

Median Home Price Changes by Region
(Year-over-Year Change—Rolling 3-Month Average)



Note: 7/03 and 8/03 San Francisco numbers not available.
Source: California Association of Realtors

New York 212-486-5800

Chicago 312-696-7800

Dallas 214-860-5200

Houston 832-366-2000

Los Angeles 310-286-6000

Miami 305-530-6200

Minneapolis 612-758-5000

San Francisco 415-217-8000

Seattle 206-342-1300

Washington, DC 202-261-6700

West Palm Beach 561-820-2100

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