



Bradley, Foster & Sargent, Inc.

Quarterly Market Commentary

January 2014

Can Connecticut's Vitality Be Restored?

The landscape architect, Frederick Law Olmsted, from Hartford, Connecticut, that nursery of genius,... designed Central Park...

Paul Johnson, *A History of the American People*

Although Bradley, Foster & Sargent has clients in 41 states and several living abroad, over 60% of our clients reside in Connecticut. As the state of Connecticut was the birthplace of our firm in 1994, and its communities and culture have been the soil from which our business has grown from \$90 million in client assets at inception to \$2.45 billion at the end of 2013, we care a lot about the economic and social trajectory of our state. And it is not a pretty picture, which concerns us mightily. It appears as if the proud heritage of Connecticut, which Paul Johnson writes about in his magisterial history of America, has been greatly diminished over the past several decades. The empirical data about the state of affairs in Connecticut – its troublesome financial situation, its anemic economy, its stagnation in jobs, its pockets of poverty, its transformation to a high tax state, and its migration of residents leaving the state – present some tough challenges to its citizens. Our purpose in this commentary is to paint a realistic portrait of the state with its current strengths and weaknesses, analyze some of the reasons we believe this decline has taken place, and point to some steps which might help restore Connecticut's rich and dynamic history of economic growth. As these topics hit close to home and can often cause partisan rancor, we sent a draft of this investment commentary to more than a half dozen respected figures in the community – including professionals in academia, the accounting profession, public policy, and the business community, and we received much helpful feedback. Any mistakes or misperceptions herein should, of course, be solely attributed to us.

Connecticut's Great Heritage

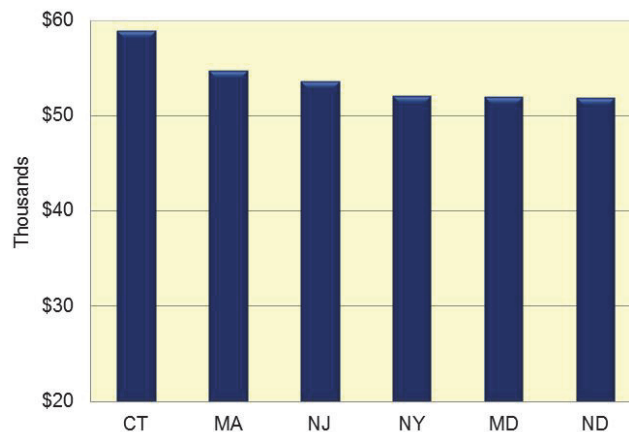
In 1636, Reverends Thomas Hooker and Samuel Stone led a band of about 100 Puritans from the Massachusetts Bay Colony to Connecticut and established the town of Hartford. In 1639, Hooker led the township of Hartford, together with the Puritan-dissenter townships of Windsor and Wethersfield, to form what they called the Fundamental Orders of Connecticut. This was the first written constitution not only in America but in the world. In fact, the very structure of the U.S. Congress was the result of the "Connecticut Compromise" proposed by Roger Sherman and Oliver Ellsworth at the Constitutional Convention in 1787. This constitutional structure, together with the sturdy and independent stock of largely British pioneers, created a society and culture which over the next several centuries yielded a veritable pantheon of American heroes. These Connecticut citizens flourished in many fields. There were two towering figures in American religious life – Jonathan Edwards, widely

acknowledged as America’s most important and original philosophical theologian, and Charles Finney, leader of America’s “Second Great Awakening.” There were great authors such as Harriet Beecher Stowe and Mark Twain as well as Noah Webster, called by many the “Father of American Scholarship and Education.” There were famous military figures in the Revolutionary War – Nathan Hale, Israel Putman, and the “Hero of the Battle of Saratoga” and later traitor, Benedict Arnold. Connecticut also produced great artists, architects, and inventors such as John Trumbull, F.L. Olmsted, and Eli Whitney. Finally, Connecticut produced the remarkable banker and financier, J.P. Morgan, who almost single-handedly prevented the collapse of the U.S. financial system in 1907. Connecticut’s economy flourished during its first 250 years, moving from agriculture to trade, shipping, manufacturing, guns, and railroads. For several decades after the Civil War, Hartford was America’s wealthiest city.

Some Economic Extremes in Connecticut

Although one-third of Connecticut’s mills closed and moved south during the Depression, the state’s economy rebounded after World War II and prospered until the last several decades of the 20th century. Nicknamed the “insurance capital of the world” with its top-rated insurance companies, the state also became known for its leading-edge defense industry. The world’s first nuclear submarine, the Nautilus, was built in Connecticut shipyards, while United Technologies continued to be a major player in the U.S. defense industry through its subsidiaries, Pratt & Whitney and Sikorsky. Connecticut has also been known for its quality manufacturing industry with its many successful small and medium size firms. However, both the insurance and defense industries, while still important to Connecticut’s economy, have reduced operations in Connecticut significantly over the past several decades. Connecticut’s economic decline began about 25 years ago, but this decline has been largely masked by the significant wealth created and accumulated by Connecticut residents over the past centuries and the high income currently earned by professionals living in Fairfield county. According to a recent CNN report, Connecticut has 4 out of America’s 25 towns with the highest median family income – New Canaan (#1), Darien (#2), Westport (#5), and Greenwich (#14). As the chart below shows, Connecticut is the state with the highest per capita income in the U.S.:

Per Capita Income – 2012



Source: Bureau of Business and Economic Research at the University of New Mexico

At the other end of the spectrum, approximately 21% of the population in Connecticut – 720,000 people – are living at or near the official U.S. poverty level. The table below lays out the statistics about poverty in some of the state’s largest urban communities based on the 2010 American Community Survey:

City	Total Population	Number of Residents Below Federal Poverty Guideline	Percentage of Very Poor Residents
Hartford	116,689	37,495	32.1%
New Haven	118,452	29,811	25.2%
Bridgeport	138,854	28,876	20.8%
Waterbury	107,670	22,532	20.9%
New Britain	70,064	14,388	20.5%

Source: Connecticut Association for Community Action, Connecticut Center for Economic Analysis, BWB Solutions

The organizations listed as sources in the above table – Connecticut Association for Community Action, Connecticut Center for Economic Analysis, and BWB Solutions – produced a report entitled *Meeting the Challenge: The Dynamics of Poverty in Connecticut*. The report makes the following valuable observations about the demographics of poverty: “Family structure often forecasts the likelihood that the family unit lives in poverty.” Specifically, the report noted that “there is a significant statistical relationship between the percentage of single female households with children in a given town, and that town’s level of poverty. For example, in 2010, if one was a member of a single-female headed household in Hartford, there was nearly an 80% chance that that household was Very Poor” – below the Federal Poverty Level. Educational attainment was also closely related to poverty in the report. “Connecticut females and males who lack a high school diploma or GED can expect to be Very Poor 72% and 67% of the time, respectively.” These observations about the root cause of poverty in Connecticut are similar to those made about other regions in the U.S., as well. Although various government initiatives have been undertaken to create healthier family structures and reduce the high school dropout rate, these have been largely unsuccessful.

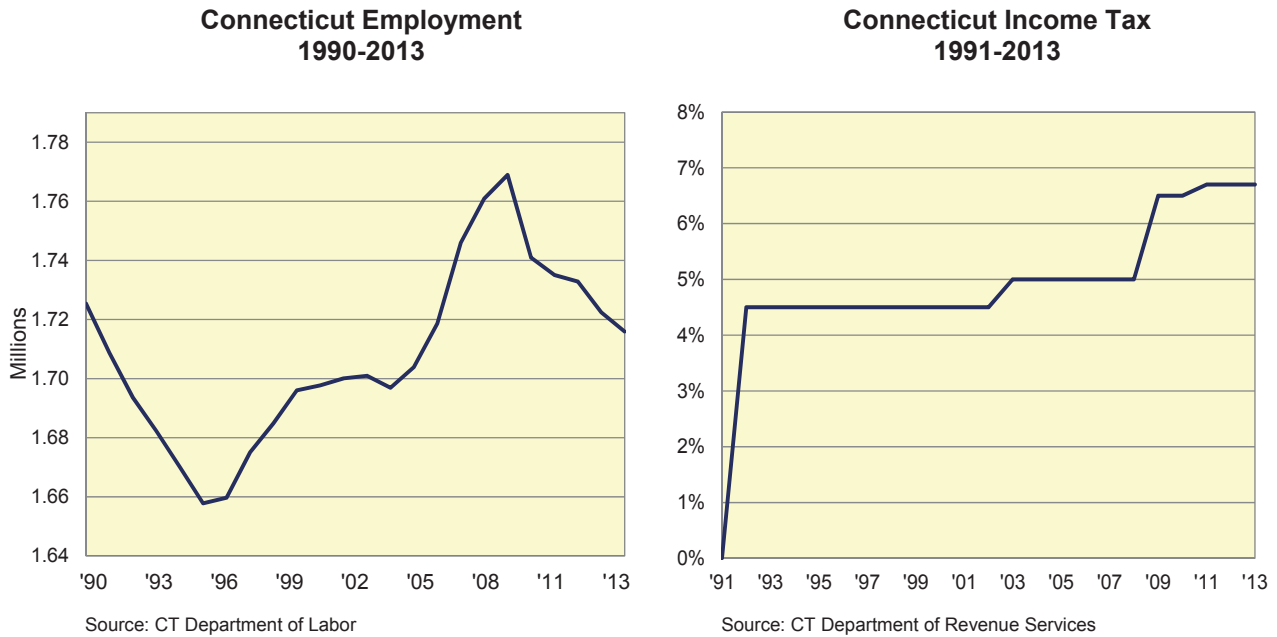
The Challenges Ahead

Connecticut’s ranking as one of the wealthiest states in the U.S. and its rich cultural heritage have possibly caused its leaders and politicians to be complacent in facing its daunting challenges. As we see it, these are the most serious problems facing the state:

- Anemic economic growth
- Lack of long-term job creation
- Exodus from Connecticut
- Explosive Growth in State Spending
- Huge Unfunded Pension and Health Care Obligations to State Retirees
- High Taxes
- Reputation as Unfriendly to Business

Many of these issues are inter-related. One of the most critical and pressing problems is the migration of individuals in their prime working years from Connecticut to other states. According to the Yankee Institute for Public Policy, Connecticut lost a net of 325,000

residents to other states between 1991 and 2008 – about one in ten residents. Generally, the former residents moved south to states such as Florida, Georgia, South Carolina, and Virginia. These are states with higher economic growth, lower taxes, and less union penetration. This exodus of Connecticut residents to other states is driven, to a significant extent, by a weak economy which has produced no net new jobs from 1990 through 2012 and by a steady increase in taxes. The charts below illustrate these problematic trends over the past 20+ years:

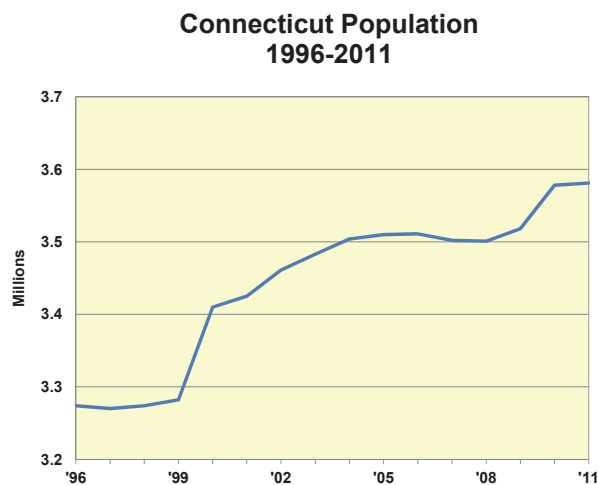


As can be seen from the charts above, Connecticut had 1.72 million jobs in 1990, and it had the same number at the end of last year. During the same period, the number of jobs in the U.S. grew by over 20%. If Connecticut had kept pace with the country as a whole, the state would now have 350,000 additional jobs.

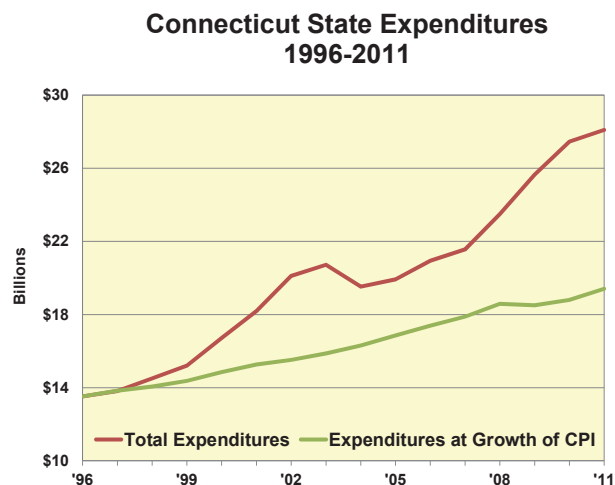
In regard to taxes, Governor Lowell Weicker in 1991 introduced Connecticut’s first-ever state income tax at 4.5%. It was meant to be the solution to Connecticut’s fiscal problems. Since then, the top marginal state income tax rate has increased 50% as the chart above shows. In addition to the state income tax, there have been many other tax increases over the past several years, including an increase in the corporate tax rate from 8.25% to 9%, an increase in the sales tax to 6.35%, and a change in the estate tax which now is levied at \$2 million rather than the previous level of \$3.5 million. A \$5 million estate now pays no Federal taxes but pays \$252,000 of Connecticut estate tax (8.4% of \$3 million). Connecticut’s estate tax, which is less onerous than many of the surrounding states, is nevertheless one of the causes for the migration out of state by many successful business owners and entrepreneurs to states which have no estate tax (and often no income tax). Connecticut’s gas tax is more than 25 cents higher than its neighbor Massachusetts currently. Massachusetts, which for years was labeled “Taxachusetts,” now has a lower tax burden on its residents than Connecticut.

The Growth Trajectory of Connecticut's Spending

Before Connecticut's state income tax was introduced in 1991, the state's annual budget was about \$7.5 billion. Since then, the budget has more than tripled (not including the state's spending on Medicaid). Since 1996, the state's population has increased by roughly 10%. However, during this same period, state expenditures have far outpaced population growth and inflation as shown in the charts below:



Source: CT Department of Public Health



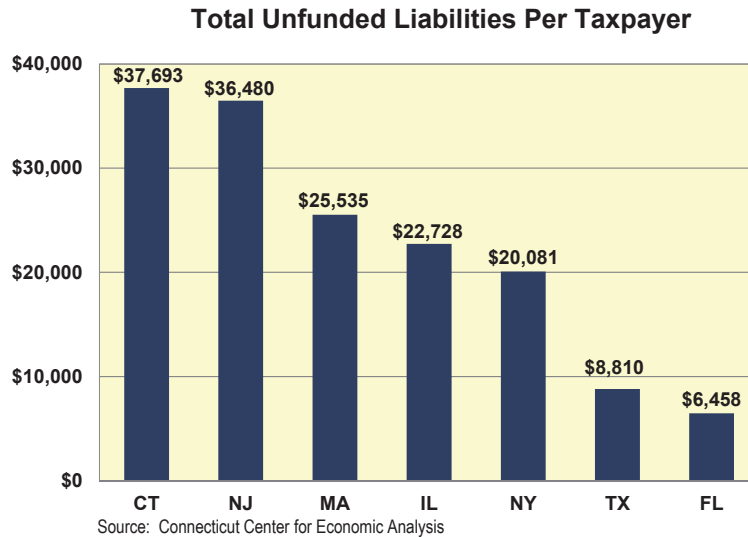
Sources: US Department of Labor - Bureau of Labor Statistics
US Census Bureau - State Government Finances

One of the measures that economists use to analyze the growth trajectory of an economy is government expenditures as a percentage of GDP. Generally, the greater the level of government spending, the more slowly an economy tends to grow. For example, both Singapore and Hong Kong, two of the fastest growing economies in the world, have nearly the lowest government spending/GDP ratios in the world, while many of the slower growing EU economies have very high ratios. In looking at annual state expenditures as a percentage of GDP for the period 2007-2011, the Comeback America Initiative and the Connecticut Center for Economic Analysis in its April 2013 Report, *Connecticut at Risk: Will the State Navigate to Prosperity?*, found that Connecticut had the 4th highest percentage of state spending to GDP – 7.6%. The states to which Connecticut residents are migrating – Florida, Georgia, South Carolina, and Virginia – are in the bottom half of the database.

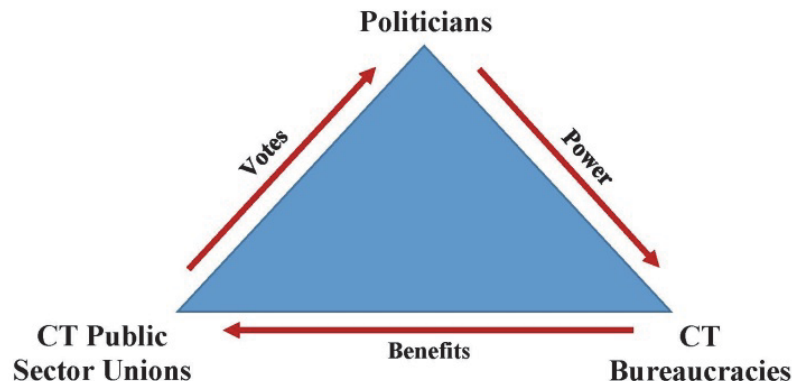
Connecticut's Funded and Unfunded Liabilities

The challenges described above, however, pale in comparison with Connecticut's fiscal situation. For years, expenditures have exceeded revenues with the state government taking on bonded debt to make up for the fiscal shortfalls. These budget shortfalls have been largely camouflaged to the public, as accounting for government entities is more flexible than for corporations. However, a recent Barron's publication ranked Connecticut 50th in the U.S. when comparing the state's combined debt and unfunded pension liabilities relative to GDP. Most investors have focused on problems facing Illinois and California in this regard and have given Connecticut a pass. Many are unaware of the state's tenuous financial situation because the problem is largely off the state's balance sheet. However, the news is spreading

that Connecticut faces great fiscal challenges. A recent well-attended presentation by the Connecticut Society of Certified Public Accountants laid out the bad news: Connecticut has pension and health care obligations to state employees and teachers of \$53 billion, of which only \$8.1 billion has been funded. This means that Connecticut residents and taxpayers have unfunded commitments of approximately \$45 billion, an enormous burden for taxpayers now and for future generations. The chart below shows the liability per Connecticut taxpayer as of June 30, 2012 compared with several other states:



The above chart illustrates the daunting challenge faced by Connecticut. Regardless of the methodology used, Connecticut has the highest level of total liabilities and unfunded obligations per taxpayer of any state in the union. This problem has been growing over a long period. Unlike many states, much of the responsibility for this problem, which stems from Connecticut’s commitments to its teachers and public service unions and its unfunded liabilities, can be laid at the doorstep of recent Republican administrations, but the overall responsibility lies with executive and legislative branches at the Connecticut statehouse over the past several decades. The buck cannot be passed any longer. Connecticut is on an unsustainable fiscal path, and action needs to be taken soon. One of the main sources of the problem is Connecticut’s iron triangle: the mutually supportive relationships between Connecticut’s public service and teachers’ unions, the politicians whom they have put in power, and the bureaucracies that serve these special interest groups. The figure below represents these relationships graphically:



The players in this iron triangle have made commitments and accrued future pensions and health care benefits which may be very difficult to keep without causing real economic damage to Connecticut citizens and the state's economy. Unless these commitments are re-negotiated and future benefit packages scaled back, Connecticut's financial situation will continue to deteriorate.

It is not widely known that President Franklin D. Roosevelt was resolutely against collective bargaining by public sector unions and, in his letter of August 6, 1937 to the President of the National Federation of Federal Employees, condemned in the strongest terms strikes by public servants. It was President Kennedy who signed Executive Order 10988 in 1962, which allowed the unionization of the federal workforce, opening the door to the inexorable rise of a unionized public work force in many states and communities. Currently only 6.6% of U.S. workers in the private sector are unionized, a percentage which has declined annually for decades; 35% of employees in the public sector, however, are unionized. These powerful public sector unions are the beneficiaries of commitments by politicians which are causing fiscal havoc in many communities. Detroit is such an example, and it is probably just the first of many community bankruptcies. Although Governor Malloy and the Connecticut Legislature have acted to lessen the off-balance sheet commitments, the steps taken were modest and came at the price of the commitment of a four-year period of no layoffs of state employees. Furthermore, Connecticut's major labor contract covering these benefits is not scheduled for re-negotiation until 2022. Connecticut does not have the luxury of that much time to redress this issue, as the state's current fiscal path is unsustainable.

Summary

Connecticut is a wealthy state with highly productive people. It has the highest per capita income in the U.S. and ranks third in the country in per capita GDP – ahead of both Massachusetts and New York. It has a strong heritage; lovely towns, beaches, and countryside; and a hard-working, productive people. Many find it a great place to live. It has world class universities, which are generating commercially viable intellectual property and helping to create spinoff businesses. In this regard, Yale has established its own venture capital initiative, which, according to one source, has already created over 30 new companies in the New Haven area. Governor Malloy's BioScience Connecticut initiative brought Jackson Laboratory's genome research to Connecticut, which is an exciting and potentially far-reaching economic endeavor.

Nevertheless, the state faces severe financial challenges in the not-too-distant future. There are no easy nostrums that will turn things around. The surest path to revitalize Connecticut's economy and help ameliorate the fiscal situation is growth. Economic growth! Connecticut needs to put into place policies and programs which will set its economy on a path to growth. To do so, it needs to enhance its competitiveness. And to accomplish this, it needs to reduce the growth of government spending. The empirical data is clear that communities which focus on growing the pie rather than cutting it into pieces, create faster-growing economies with more jobs and more opportunities for its citizens.

A steeper growth trajectory is brought about by lower taxation and less intrusive regulation. If this occurs, entrepreneurs and business owners will stay in Connecticut and risk their capital, creating more jobs and economic growth, rather than leaving for more propitious climes, and new businesses will spring up rapidly.

Secondly, Connecticut must curtail its huge funded and unfunded liabilities. To do so, voters must understand Connecticut's daunting fiscal problems and elect politicians who are willing to make some hard decisions and take unpopular steps to reverse Connecticut's current worrisome trajectory. Investors in Connecticut tax-exempt bonds need to go beyond the simplistic rating systems of Standard & Poor's, Moody's, and Fitch, and understand the issues that are at stake. At this time, we continue to hold Connecticut state obligations for some of our clients, but we pay careful attention to these positions and review them frequently. We, at Bradley, Foster & Sargent, believe that Connecticut can have a future which is as great as its past. It will, however, require a concerned citizenry and political leaders with courage and conviction to take action now in order to revitalize Connecticut's economy and put the state back on a path to prosperity which will benefit all its citizens and future generations as well.

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