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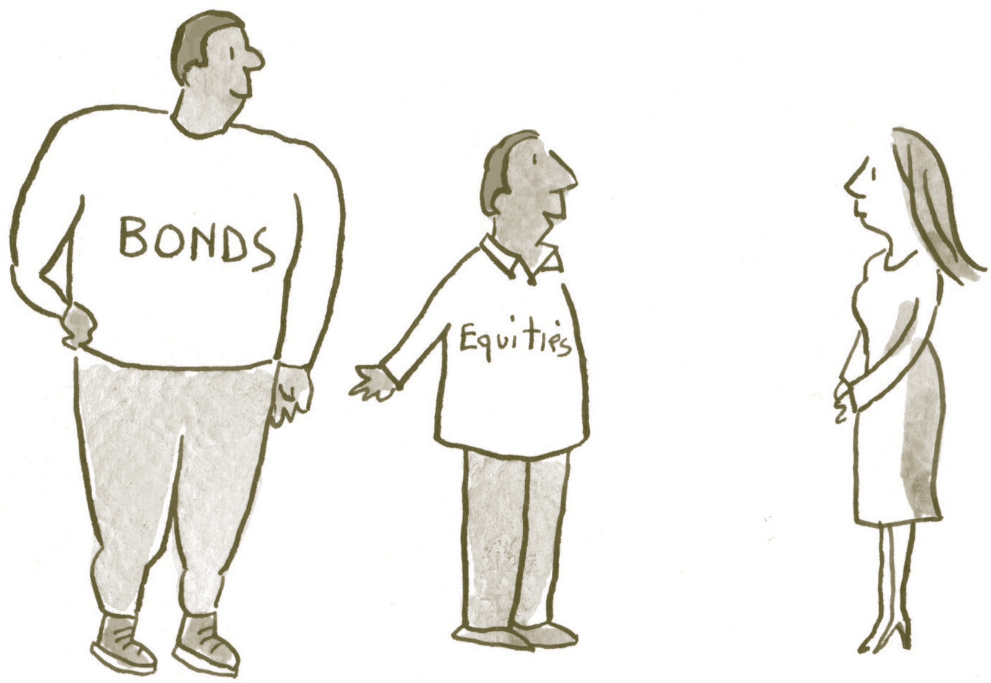
Understanding the Dynamics of The Municipal Bond Market



"My little brother is a big deal."

The municipal bond market serves a great purpose, as these securities are critical to building and maintaining the infrastructure of our nation. Two-thirds of infrastructure projects in the U.S. are financed by municipal bonds. In the U.S., there are over 80,000 state and local governments, about 50,000 of which have issued municipal securities. There are approximately one million different issues outstanding, totaling $3.9 trillion. American households hold over 80% of these issues, either directly through individual securities or indirectly through mutual funds and exchange-traded funds. »

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No other capital market encompasses so many issuers and so many securities. The differences among issuers are broad, as are the purpose of the offerings. Municipal bonds are a necessary instrument to fund basic governmental functions, including a variety of state, county, and city needs for infrastructure, such as schools, public facilities, transportation, utilities, health care, and housing, as well as some private purposes, such as to enhance economic development.

Why invest in municipal bonds?

Individuals and institutions find value in investing in the debt of important national infrastructure needs and, in most cases, receive considerable tax benefits.

Our clients that invest in municipal bonds have built wealth over time, and their objective for this allocation turns to preserving the purchasing power of these assets. This is accomplished by generating a consistent tax-advantaged income stream based on available market interest rates.

Despite the appeal, municipal bonds are not without risks, nor is acquiring the appropriate exposures without challenges.

The size and scope of the municipal market are broad. However, the pool of available securities is never the same or constant. Issuance, supply, and demand ebb and flow. As such, we are selective and diligent in our portfolio construction.

What segments of the municipal market does RMB gravitate toward?

Municipal issuers need to source income to support the cash flow requirements of their debt issues. Issuer funding sources generally fall into two categories, tax-backed and revenue-backed, each having their own subsectors, caveats, and underwriting standards regionally and by public need. Both tax-backed and revenue-backed sources have their strengths and weaknesses. Historically, certain structures have fared better than others. All are susceptible to a variety of market risks to varying degrees.

For tax-backed securities, we typically invest in state and local general obligation bonds supported by ad valorem property taxes.[1] Cash flows are supported by the taxing authority of the issuer. We usually avoid dedicated tax, special tax, and tax allocation bonds, as well as tax appropriated bonds. The value lies in the taxing authority's ability to apply tax collections to the entire universe of households rather than being limited to the tax revenue generated by a single project.

For revenue-backed securities, we generally invest in utility sources such as electric, water, and sewer. Cash flows are supported by the revenues generated from the underlying necessary business operations. We tend to avoid issues with nonessential service revenue sources in most circumstances. These include parking structures, sports venues and convention centers, and industrial development revenue bonds, to name a few.

The securities we favor tend to have more reliable and consistent cash flows. We make considerable efforts to avoid municipal issues whose funding structures can rapidly deteriorate in weaker periods of an economic cycle and during periods of extreme market stress.

What are some major selection considerations?

With preservation of capital as a primary consideration, we examine the leading associated risk in the municipal bond universe, default risk. Taking into account the historical record of defaults, RMB gravitates to a much narrower subset and less volatile universe of securities for our portfolios.

Since 1970, three-quarters of municipal defaults have been in "competitive enterprises." »

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This group includes not-for-profit enterprises such as housing, higher education, and health care. It also includes project financings that have high enterprise risk, such as sports venues or convention centers. Avoiding competitive enterprises minimizes default risk significantly.

Additionally, state and local governments' liabilities and leverage have grown substantially in the last decade, primarily because of pension liabilities. Unfunded pension liabilities for state and local governments barely existed fifteen to twenty years ago but now total approximately $5 trillion. Current pension liability funding ratios are a major concern. We are vigilant when examining municipalities with below-average pension liability funding ratios.

What are some of the evaluation metrics we use for investment?

In addition to avoiding higher-risk subsets of the municipal market, credit ratings have served as and remain the most consistent gauge of overall risk. In the last fifty years, 90% of all municipal defaults had speculative-grade (junk) ratings at the time of default, and 70% had speculative-grade ratings one year before default. The median rating one year before default was Ba3, while the median rating five years before was Baa3, one notch above speculative grade. By continuously monitoring credit ratings and credit risk and restricting our purchases and holdings to the upper spectrum of the investment grade universe, we can do much to insulate the portfolio risk exposure.

Audited financial statements are also key to assessing future default risk. Financial statements for municipal issuers are neither timely nor subject to the same level of regulation as other sectors of the U.S. capital markets. In fact, audited financial statement submissions average around 200 days after the end of the applicable fiscal year. We examine what is most current as well as the historical record. We examine and have tolerance thresholds for levels of indebtedness, coverage ratios, general fund balances, and other relevant economic and demographic data.

How do we identify relative value, and how do we trade municipal bonds in the marketplace?

Municipal bond market information and price transparency is improving but is still opaque. Our portfolio management team constantly monitors daily credit curves, dialogues with our network of broker-dealers, reviews new issuance, scans dealer inventories, and assesses real-time trades to identify value, reduce risks, and capitalize on opportunities.

Because of the large number of outstanding municipal securities and the infrequent trading of specific securities in this market, there is no centralized exchange marketplace. Instead, municipal securities trade "over the counter." Trading requires knowledge and experience of the marketplace and the understanding and ability to negotiate for the best price. We engage with many national and regional broker dealers as well as several electronic platforms and trading systems to optimize our coverage, liquidity, and pricing leverage. We utilize all our resources to obtain the best execution.

Performance measurement.

RMB municipal bond portfolios are high quality, short to intermediate duration, regionally and compositionally diversified, and structured in accordance with diligent criteria. We use performance benchmarks that are similar in these aspects. However, no benchmark exists that perfectly aligns with our philosophy and approach. Benchmarks contain thousands of securities and are a broad market-weighted representation of issuance in the marketplace. They are skewed to the largest issuers and states of the greatest issuance.

Our portfolios will always differ in composition, quality, region, and structure based on the parameters of our philosophy and approach. For our municipal bond strategies, our objective is to preserve capital, provide reliable tax-efficient income, and maintain a quality portfolio through disciplined and conscientious » portfolio management. Benchmarks are an informative piece of data that add value to our process but are secondary to our true goal, which is to build quality, tax-advantaged portfolios that protect principal and provide future purchasing power.

Impact of changing interest rates on bonds.

Interest rate changes can and will affect the price of a municipal bond. Interest rate changes are inversely related to the price of a bond. Rising rate discussions have increased the anxiety and created undue fear around the propensity for losses in the fixed income market. Interest rate changes are nothing to fear, particularly in a separately managed bond strategy. There is nothing to fear outside of default risk for losses on individual bonds if held to maturity. We have discussed at length the steps we take to minimize that risk. Although the price of a bond may fluctuate with changes in interest rates, it will earn the yield to maturity from the original investment date to the maturity date at par value. That said, in the current environment, an investor should favor yields to rise quickly. This allows cash flows and maturities to be invested at higher yields, and higher yields equate to higher income, higher expected returns, and a more productive tax-advantaged income stream. ■

1 An ad valorem tax is a tax based on the assessed value of an item, such as real estate or personal property. The most common ad valorem taxes are property taxes levied on real estate.

Excerpts from:

- *Moody's Investors Service. US Municipal Bond Defaults and Recoveries, 1970-2016, June 27, 2017*
- *Municipal Securities Rulemaking Board. Trends in Municipal Bond Ownership, 2017*
- *Municipal Securities Rulemaking Board. Self-Regulation and the Municipal Securities Market, January 2018*
- *Municipal Securities Rulemaking Board. Timing of Annual Financial Disclosures by Issuers of Municipal Securities, February 2017*
- *U.S. Securities and Exchange Commission. Report on the Municipal Securities Market, July 31, 2012*