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Sector Selectivity

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Many cities and states face significant financial challenges ahead from the effects of the COVID-19 pandemic. APA believes that professional portfolio management and an ongoing credit-review process can help minimize investors' risk and add value for our clients where we see opportunity. This paper examines the sectors that we believe may be more insulated from downturn as we navigate a rapidly changing economic environment.

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Cautious investors searching for shelter often seek sanctuary in investment grade municipal bonds, which over the past fifty-years have offered low rates of default. But the COVID-19 pandemic threatens to infect that safe haven, too. Many state and local governments are under extra stress these days to deliver basic services *and* protect the public health, all with smaller transfusions of their lifeblood, sales taxes, the result of millions of furloughed or unemployed Americans spending less to conserve their shrinking paychecks.

Although difficult to predict the ultimate effects in the United States of this worldwide emergency, even after nation-wide quarantines end and the economy restarts, Asset Preservation Advisors (APA) believes that the default risk of high-quality, high-rated municipals remains low. The more likely peril: the widespread downgrading of issuers by the ratings agencies. Now more than ever, navigating the roiling seas of uncertainty requires professional portfolio management, and APA continues to emphasize high-quality, investment-grade municipal bonds, particularly in these uncertain times.

Focus on Quality

APA is concentrating on sectors that we believe are more insulated from credit deterioration and the risks associated with underfunded-pension liabilities. Specifically, we continue to focus on water, sewer, and electric bonds because of those services' indispensability in Americans' everyday lives. Even in tough times, customers are likely to always pay those bills to avoid shutoff. Also, issuers of such bonds usually have more than sufficient liquidity and offer bondholder protections including rate covenants, debt-service-coverage-level minimums and a reserve fund. In addition, certain school bonds are attractive because of their reliance on a dependable source of revenue — property taxes — and state enhancement programs. APA avoids issuers with exposure to risks associated with underfunded pension obligations, at both the state and local level. We maintain that underlying, pension-related financial metrics provide insight into the overall credit strength and discipline of the issuer. Additionally, many high-quality municipal securities have backstops for investors, notably state guarantees, the backing of permanent school funds, and a history of strong cash reserves. Securities with characteristics like those, APA believes, are likely to retain their value, even during unpredictable periods.

Historically Low Defaults Across High-Quality Ratings Categories
1970-2018

		Municipal Bonds	Corporate Bonds
Invesment Grade	Aaa	0.00%	0.00%
	Aa	0.04%	0.63%
	A	0.27%	0.96%
	Baa	1.57%	1.69%
High Yield	Ba	5.24%	7.69%
	B	19.36%	19.82%
	Caa to C	56.04%	39.86%
Totals	High Yield	12.35%	22.06%
	Investment Grade	0.18%	1.20%
	All Rated	0.29%	8.84%

Source: Moody's Investors Service; Default Recovery, Data Report 6 August 2019

APA Targeted Municipal Sector Overweight's

Sector	Rationale
School Districts	Enhancement programs, prefer property tax based, high collection rates, lower expenses while not physically operating, single source of service (education)
Water Revenue Bonds	Essential service, increase in usage, typically have strong liquidity levels, additional bond holder protections such as rate covenants and reserve funds
Sewer Revenue Bonds	Essential service, increase in usage, typically have strong liquidity levels, additional bond holder protections such as rate covenants and reserve funds
Electric Revenue Bonds	Essential service, increase in usage, typically have strong liquidity levels, additional bond holder protections such as rate covenants and reserve funds

Credit Fundamentals

In this financial environment, APA favors issuers that meet certain credit criteria, with credit fundamentals such as:

1) Above average liquidity (measured in Days Cash on Hand, or, simply, how many days a state, municipality, or business can pay its operating expenses with the amount of cash available)

2) Low debt levels relative to the median for their ratings category and sector

3) Reliance on property taxes, not sales taxes, as their primary revenue source, thereby better shielding them from the effects of an economic downturn

Mitigating exposure to issuers more at risk now, requires continuous review of all bond holdings. Although many cities and states face significant financial challenges ahead, APA believes that professional portfolio management and an ongoing credit-review process can help minimize investors' risk and add value for our clients.

For more information about Asset Preservation Advisors customized portfolio management, please contact:

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Disclosures: