Municipal Bonds: Seeing the Forest Through the Trees

September, 2020

ASSET PRESERVATION ADVISORS

- We acknowledge that in the current environment, municipal credit quality is as vital as ever. We fully expect to see issuer downgrades, as state and local governments deal with cost increases while revenues have declined.
- Positively, municipalities entered this economic shock on relatively sound footing; many had been building up reserve fund balances, and credit rating upgrades outpaced downgrades over the past several years.
- Municipals are and remain a high-quality asset class – with over 70% of outstanding bonds rated AAA/AA. As such, the market can stomach what will likely be mostly innocuous downgrades; a hypothetical move from Aa1 to Aa2 is not tremendous, and even a multi-notch downgrade from AA to A still puts a credit solidly in the investment grate spectrum.
- A large portion of the market consists of revenue bonds backed by essential services. These issuers tend to be very resilient, with revenues derived from specific uses/sources. In extreme cases, they can enact rate hikes if needed to stabilize revenues.
- Historically, muni default rates are extremely low. Per Moody's data, historical investment grade muni default rates are 0.10%, vs. investment grade corporates 2.25%.
- APA continues to view defaults and default risk as skewed to the high-yield sector of the market. We believe the fundamentals remain solid that investors seek in high-quality tax-exempt municipal bonds.

Recently published articles have shed light on specific credit quality concerns within the municipal bond market as the economic impacts of the pandemic have become more apparent. Asset Preservation Advisors (APA) believes these pieces should not dissuade investors from realizing the potential benefits of their tax-free municipal bond allocation but should emphasize the importance of professional management and continuous credit research and monitoring.

State and local governments are under extra stress these days to deliver essential services and protect the public health, with fewer tax revenues, in part the result of millions of furloughed or unemployed Americans spending less to conserve shrinking paychecks. However, many states entered this period with solid financials, low-debt levels, strong liquidity, and high pension funding ratios. This is evidenced by 15 states carrying a rating of AAA. Additionally, for many high-quality issuers, the cost of debt service is only a small percentage of their overall annual expenses. The median debt service carrying cost for a AAA-rated city, for example is approximately 8% of total expenses and 9% for a AA-rated city, respectively.[1]

APA believes that the default risk of high-quality, highly rated municipal bonds remains low. The more likely peril: the widespread downgrading of issuers by the rating agencies. We remain highly selective in states with low pension funding ratios and continue to focus on high-quality credits that we believe to be more insulated. Reliant on our internal credit research, APA continuously reviews each credit in our clients' portfolios and makes investment decisions independent of the rating agencies. Through a rigorous bottom-up approach using several inputs, we identify bonds that meet our credit criteria and look to purchase at levels congruent with our internal credit rating, to stay ahead of and cushion against any potential future downgrades. We continue to navigate the municipal market, focusing on those sectors and individual securities that we believe will be most insulated from the effects of this pandemic and seek to uncover areas in which we see value. See chart below for a sampling of key inputs that we consider with each bond review.

CREDIT REVIEW PROCESS KEY INPUTS

General Obligations (State/City/County)	Special Revenue (i.e. Hospitals)
Purpose of Project	Purpose of Project
Population Size & Growth/Decline	Market Share (Based on Admissions)
Economy (Unemployment, etc.)	Total Operating Revenue
Wealth (Per Capita Income, % Poverty etc.)	Operating Margins
Top Ten Taxpayers	Payer Mix (% Medicare, % Medicaid, % Self-Paid)
General Fund Balance	Average Age of Property, Plant and Equipment
Liquidity (Days Cash on Hand)	Liquidity (Days Cash on Hand)
Expenses	Debt Service Coverage
Debt Levels (% Assessed Value & Per Capita)	Debt Ratios (LT Debt/Capital)
Pension Obligations (OPEB)	Reliance on State/Federal Funding

Source: APA, June 2020

For more information about Asset Preservation Advisors customized portfolio management, please contact:
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[1] *Merritt Research Services LLC; city medians as of FY 2019*

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