Defusing the Ticking Time Bomb (1/29/2018)

Saturday's edition of BARRON'S included an article titled, "The Ticking Time Bomb in the Municipal-Bond Market". In our opinion, the contents of this article outline only a fraction of the credit risks inherent in the municipal bond market. When we opened our doors in 2005, these issues were present, and are certainly more pronounced today. Since that time, many states have doubled down on practices of reckless spending and irresponsible borrowing. These concerns have and will remain at the forefront of how we manage money at RSW. While some of our past commentaries may have sounded "too negative" for some, we have always believed that credit risk in the municipal bond market is real, not an illusion.

While the author mentions some of the risks present in the state of New Jersey, we believe they only begin to scratch the surface of the hazards present within the state. In addition to budgetary imbalances in New Jersey, the state of Illinois is for all intents and purposes a "basket case". In fact, Bloomberg.com reported on Friday that Illinois is considering an unprecedented measure. According to the article, "*Lawmakers in Illinois are so desperate to shore up the state's massively underfunded retirement system that they're willing to entertain an eye-popping wager: Borrowing $107 billion and letting it ride in the financial markets."* These problems have been present for anyone who was just willing to look. Moreover, as investment managers, you must continuously assess risk when compared to the potential reward. This serves to explain why for over a decade, we haven't lent a dime to the state of Illinois or virtually any of its municipalities.

At RSW, we will continue to shun states and municipalities with significant unfunded pension obligations. Connecticut and Pennsylvania are also prime examples of states that have been and remain on our radar. Both states have been subjected to multiple credit rating downgrades with more to come. Our proactive approach to credit analysis has allowed us to avoid distressed borrowers and in the case of the higher tax states, minimize our maturity / duration positioning.

We have always sought to share our market and issuer views with candor, clarity and consistency. For example, in the recent past we have said:

From: 1st Quarter Fixed Income Newsletter (4/6/2016):
Pension issues in Chicago and Illinois (is New Jersey next?) are not to be resolved without further hardship to taxpayers and bondholders. The deterioration in these credits is well known and will only prove to get worse.

From 2015 Q1 Quarterly Commentary (4/17/2015):
While state and local governments have cut billions in spending, pressures persist especially in core areas such as health and education, notwithstanding the "800-pound gorilla in the room" – pension liabilities.

From time to time, our management team is confronted with calls from our clients questioning the returns of our strategy, comparing our investment results to a handful of competitors who tout their outsized yield and total rate of returns. On these calls, we remind our clients that when managing municipal bond portfolios, the generation of income and price appreciation primarily comes from three sources: interest rate risk (as measured by duration), maturity positioning and credit risk. If you want to post higher returns, you must take risk in at least one of these areas. There is no free lunch!

In prior RSW commentaries, we have often proclaimed, “This is not your grandfather’s municipal bond market”. This statement is not meant as a marketing tool to tout the benefits of our credit research skills, but rather our core belief. We remain cautious in our approach to managing the risks inherent in this asset class as evidenced by our current portfolio positioning. Our first task as investment managers is to deliver relatively high total rate of returns while embracing a prudent level of risk. Looking ahead, we will continue to assess the credit worthiness of borrowers utilizing a rigid approach, while assuaging clients who are starving for incremental yield.

As always, please feel free to contact us to share your thoughts or if you would like to discuss further.

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