Motor City: The “Coffers” are Truly Bare (7/22/13)

The bankruptcy filing by Detroit is an American tragedy with human and financial consequences. The city's deterioration has been 50 years in the making, and thus the bankruptcy was unsurprising and widely anticipated by market participants for at least a year.

What is not yet known is whether this event will cause mutual fund investors to impulsively liquidate a portion of their mutual fund holdings, forcing fund managers to sell bonds, putting additional downward pressure on municipal bond prices.

We believe that any such effect will ultimately be short-lived, and should be smaller and shorter in duration than the impact that occurred in the aftermath of Meredith Whitney's misstatements on 60 Minutes. This is because we believe Detroit's bankruptcy filing is viewed as a singular event, and in a “league of its own.”

To date, various municipal market participants expressed strong opinions and concerns regarding the failure of the “current” bankruptcy plan to differentiate between the stronger full faith and credit pledge of bondholders, versus the claims of pensioners and what is defined as other unsecured debt holders.

In short, we do not see this as an issue for the “overall” municipal market.

With respect to Detroit’s financial position, in this case, the “coffers are truly bare”. The Detroit fiscal pie has shrunk dramatically. In the end, all participants will share the heavy loss: bondholders, employees, and pensioners. It is up to a bankruptcy judge to decide how best to divide the pennies on the dollar that will ultimately remain in this case. For investors, the borrower's ability to pay counts more than contractual obligations.

It should also be noted that the overwhelming majority of Detroit's debt obligations are enhanced by municipal bond insurance contracts. RSW investment policy has always been to disregard municipal bond insurance and to look through to the underlying creditworthiness.

At RSW, our credit research is not focused on attempting to determine how the remaining assets in a bankruptcy will be divided among creditors. Instead, our resources are spent assessing the financial health of the issuer at the time of purchase, and, once owned, a rigorous ongoing credit surveillance process is continuously applied. To further insulate our clients from bankruptcy risk, we employ a stringent sell discipline, whereby issuer exposure is targeted for sale if the credit ratings fall to "BBB" (lowest tier of investment grade) category.

Looking forward, we do not anticipate that any other investment grade major issuer of municipal bonds will file for bankruptcy -- either in the immediate or short-term future. Despite the recent downgrades and fiscal problems being experienced by Chicago, the State of Illinois, and the Commonwealth of Puerto Rico, their bonds remain at “low” investment grade ratings (issuers not purchased by RSW for client accounts).

RSW client holdings also do not, and have not, included investments in any distressed jurisdictions to-date including: Jefferson County AL, Stockton CA, Vallejo CA, San Bernardino CA, and Harrisburg PA.

Lastly, our investment philosophy will consistently look to preserve client capital, while maximizing tax-free income with minimal credit exposure.

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