Key Questions

Are Municipal Bond Investors Justly Concerned?

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With all of the stress on municipalities caused by COVID-19, it's important to remember not all are created equal. Some municipalities will manage the crisis well, while others will struggle.

Over the past several months, COVID-19-related shutdowns have affected nearly every country, business, and person in the world. Your local governments and entities are no exception. The security behind municipal bonds has come into sharp focus as the shutdowns began to sweep through the United States, causing many investors to be concerned over the severe reduction in municipal revenues.
Two examples of lost revenue include income tax and sales tax. Income tax revenue is being lost due to the dramatic rise in unemployment, while sales tax revenue is being lost as a result of the slump in retail sales caused by stay-at-home orders in many states.

When these revenues are lost, the municipality has a lower amount of funds available to cover outstanding financial obligations, resulting in lower debt service coverage levels. Without a clear way to regain the lost revenues, lower coverage levels will eventually lead to downward rating pressure if municipalities are unable to adjust funding appropriately and/or were not adequately prepared prior to the crisis. Many analysts hope that the federal government will step in to plug the lost revenue hole, but this remains an uncertainty as "politics as usual" comes into play in Washington.

While we are closely following municipal credit concerns, our aggregate municipal portfolio entered the crisis period relatively well-positioned. Approximately three-fourths of our municipal holdings are rated AA or better (high-quality) and approximately one-third of our municipal holdings are insured by a suitable bond insurer.

The higher ratings signify that these municipalities are better positioned relative to other local governments to navigate the crisis due to stronger reserves, a more manageable debt burden, or a combination of factors. Put simply, these are the municipalities that are prepared.

The lower-rated municipalities are issuers that are not as well-prepared and will encounter comparatively far more challenges in the months ahead. As for the insured holdings, these bonds come with the added security that if a municipality is unable to make a debt service payment, the insurer will step in and make the payment with no disruption in payment to the investor. The reason our municipal portfolio was well-positioned prior to the crisis was not due to luck: It was the result of the process-driven approach and guidelines the team developed and follows when investing in municipal bonds.

Reflecting our conservative approach to municipal bond selection, our process guidelines include several demanding criteria that must be met for a bond to be eligible for purchase.

In most cases, low-quality bonds deserve a greater level of scrutiny than high-quality bonds.

While a high-quality bond may be deemed eligible for purchase directly by the municipal portfolio management team, a low-quality bond will need a full analyst review before becoming eligible for inclusion in a municipal portfolio.

An analyst review consists of an assessment of the municipality's financials, a review of trends in select credit metrics, a comparison to the peer group, and an evaluation of the current rating in our proprietary scoring model. Our proprietary scoring model is a stress test to determine if the current rating is appropriate as is or more likely to experience an upgrade or downgrade in the future.

After conducting the review, the analyst will then decide if the bond should be eligible for purchase. If the analyst determines the bond is not suitable, the bond is not purchased. If the bond is deemed suitable and the municipal portfolio management team finds the pricing attractive, the bond is purchased. This process should give clients confidence that when we purchase bonds, we are only purchasing what we view as "best in class."

However, the process does not stop there. As soon as the municipal bond is owned in the portfolio, the bond enters our comprehensive surveillance process. The surveillance process consists of multiple ongoing steps that include:

- Ongoing analysis of stressed or weaker credits.
- Daily monitoring of rating changes.
- Monthly examination of watch negative outlooks.
- Monthly review of newly held securities.
- Annual review of the entire municipal portfolio.

The surveillance process allows the team to "red-flag" any bonds that may not be in the best interest of our clients to continue holding due to changing fundamental circumstances.

The frequency with which the team conducts the surveillance process allows ample time to make decisions to sell fixed income securities at opportune moments. The surveillance process should provide clients comfort knowing that bonds held in their portfolios are diligently monitored after purchase.

While the municipal market is making headlines due to the stress caused by the COVID-19 shutdowns, we must remember that not all municipalities are created equal. Some municipalities will manage the crisis well while others will struggle greatly: Security selection is key and can make all the difference. At Key Private Bank, our team has built a robust process to ensure our clients are positioned appropriately to manage the municipal bond risks.

There is one maxim in particular that our team keeps in mind: "Municipal bonds are for staying rich, not getting rich." Our process steadfastly adheres to the spirit of this saying.

For more information, please contact your Key Private Bank Advisor.

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