Bond Case Briefs

Municipal Finance Law Since 1971

Credit Ratings Don't Always Tell The Whole Story.

Dusty Self: RidgeWorth is a multi boutique global asset management firm with about $37 billion in assets under management. We offer 28 different mutual funds, both equity and fixed income. At RidgeWorth SEIX, We manage approximately $1.5 billion in the investment grade tax-exempt space. We have three state-specific funds, and we have three national funds that cover the spectrum of the maturity schedule including a long fund, an intermediate fund, and the RidgeWorth Seix Short-Term Municipal Bond Fund (SMMAX), which I manage. This fund has an average maturity of three years or less. But our common strategy across all of these products is that we're active total return managers.

That means we believe in investing in undervalued securities, or sectors that have improving fundamentals, because we're looking for principal appreciation. So buy and hold is fine if you never have to sell before maturity, but we think that investors are leaving too much on the table, and that your allocation to municipal should work harder for you. It's not just about buying at the right price. It's also about knowing when to get out. So identifying securities that are overvalued, or sectors that may have declining fundamentals. Looking for those yellow flags helps you limit your downside risk — and that's our emphasis.

Our investment strategy has been in place for more than 20 years. It centers around three main principals. We believe that 1) interest rates cannot be forecast with any certainty, 2) inefficiencies in the municipal market create investment opportunities, and 3) investors should look beyond yield, to look at quality.

The municipal market has been in this evolution since the credit crisis, where it was this homogeneous mostly-insured AAA-rated market, to now becoming a credit-driven market that has more than 60,000 issuers. So credits and issuers with the same rating just do not have the same underlying fundamentals. And there's even differences between states. Some states have legislation to protect holders of their general obligation bonds, and others do not. So when you're trying to value — or appropriately value — a security, you have to consider all of those things that go into determining value.

So let me give you an example of two states: California and Pennsylvania. And they're both rated Aa3 by Moody's and AA- by S&P. California has legislation in place that provides for the legal protection of its general obligation bond holders. It's got a budget surplus, a rainy day fund, pension plans that are funded 75% to 80%, and a growing and diversified economy. Conversely though, you have Pennsylvania, which has a significantly under-funded pension plan at 51%. It's had a budget impasse for the past eight months and is considering diverting gaming revenue into the general fund so it can make those pension payments. And it provides no legislative protection for its general obligation bond holders.

You have two states that are rated the same, but on very different trajectories that offer very different yields. So we don't think that you should be just chasing yield. When you have 50 different states with their own constitutions, their own legislatures, their own laws, their own political risk, in our minds you have a lot of opportunity but for an individual there is more risk than they realize. In general, the underlying strength of the municipal market, we think, is a reflection of the moderately growing economy.

As a result, defaults remain relatively low and we're seeing upgrades outpacing downgrades for the first time in seven years. So this safety and this low correlation with other asset classes really make a strong case to invest in municipal bonds. But you need to be extremely careful, and make sure that you understand the relative value and what is behind the bonds that you're purchasing.

Wally Forbes: Interesting perspective. How about some examples?

Self: Beyond the differences between the states, we're very concerned about local general obligations. We continue to see that pensioners are being favored over bond holders. And when you see these legacy liabilities, that pensions and OPEB (other post-employment benefit) obligations are crowding out infrastructure spending at the state level, that is the start of a bad situation.

When that happens, what you're doing is that you are pitting pensioners against other constituents. Looking forward, should we slip into a recession and states again run into larger budget issues, the state is going to force down to the local level some of what it can't pay. They're going to pass that down to the local level and make it the local government's responsibility. So we're really concerned about the impact of OPEB and pension liabilities on local general obligation sector, and how they're going to be able to respond in the upcoming fiscal years.

Forbes: That sounds like it could be a big trap.

Self: It could be very tricky. We've seen many states that used the political cover of the recession to make very difficult fiscal policy changes. And they seem to be doing okay. But then there are other states that really did not get out in front of some of their issues, and now it's going to be time to pay the piper.

Geographically, we look throughout the country, because we're looking for relative value. So we're looking for opportunities of something that's trading cheap, historically, or something that's trading expensive. We're constantly looking throughout the country, and what's available in the municipal market. Geographically, we continue to like California, Florida, and the western states. They all have strong, stable, and diversified economies. And you continue to see growth in the migration into those Sunbelt warmer states.

Another sector we like is transportation. And that encompasses a couple of different mini-sectors. We like airports. The larger hubs, where passenger traffic continues to increase and in general lower oil has been a benefit. But we're going to bifurcate that area a little bit. We're going to stay away from the regional hubs where maybe it's not as easy for them to turn a profit because of a decline in passenger traffic or a carrier has pulled out.

Similarly, seaports. Even with the expansion of the Panama Canal, we continue to see improved traffic in the seaports. And we still like toll roads. Even though we realize that toll roads are tied to the economy, we're still watching them. So far, they're fundamentally sound. And we've seen an increase in issuance with the private-public partnerships and view that as a credit positive for the toll road sector. We think it is going to provide some improved relative value and principal appreciation going forward.

Forbes: Are there any particular issues that you think are especially attractive and can you tell people how to go ahead and buy them?

Self: The things that we like to take a look at are issues that somewhat get mispriced. One example, we like Chicago Airport. When they came out with a new bond deal last fall it was priced cheap from a relative value perspective, it had a little bit of taint, because of the name. But it's a separate entity from the city. So they have little to no pension exposure. They've seen the increase in passenger traffic. And just because they had the Chicago name, we saw them trade a little bit cheaper.

Since then, more news has gotten out. People are learning who's really behind, or what is really behind the bonds that they own. And we've seen the spread on the Chicago bonds improve. Similarly, we like the Port of Seattle in Washington, where it's a dual backing bond that means 70% of the revenue comes from the airport, and 30% comes from the seaport. So any sort of bond where you have multiple revenue streams, or you have confirmed revenue streams, where you know exactly how that bond is going to get paid, those are the things that we look for. We want that certainty.

Forbes: That sounds very interesting, and makes a lot of sense. As an individual investor, how do you go about getting to some of these kinds of opportunities? Just do it through your broker?

Self: For a total return strategy an investor would be best served in a mutual fund like the RidgeWorth Seix Funds. Remember we are looking throughout the county for securities that are mispriced and undervalued every day. It could be very difficult to do it through your broker. Available to the public is the emma.msrb.org website, which will include some disclosures and information on municipal securities that you can read. You can also ask your broker about where the revenue stream payments are coming from, and get some background information but the level of disclosure in the municipal market is unlike any other market. It can be a difficult and lengthy process to get information.

Forbes: And that is a website that has municipal bonds listed on it, or what?

Self: It's just information. It's access to the municipal market that has information about disclosures. It also has some trading information, current trading information on securities.

Forbes: How does one tell a better security from a less-good security? Can you do that on the website?

Self: It will help you find comparative price discovery and can help you sort through similar structures, similar maturities, similar credit ratings but remember my example of California and Pennsylvania, credit ratings don't always tell the whole story. These are the types of things that we're looking at when we are purchasing for our mutual funds. We have a credit team with over 28 years of experience in place that spends their time doing analysis. For the individual investor, it is a lot of information to have to filter through and then try to compare and make an informed decision.

Forbes: This has been a different investment area than we usually cover and I'm sure it will be of interest to our readers at this time when good income is a little hard to get.

Self: That is so true, in today's market good income is hard to come by.

Forbes: Dusty, thank you for taking the time to join us.

Self: Thank you, Wally.

AN INTERVIEW WITH

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APR 5, 2016 @ 11:19 AM

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