

# **Bond Case Briefs**

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## **California Municipal Bond Investors Must Do This While They 'Stay At Home'**

Year in and year out, California consistently tops the nation in bond issuance.

The Office of the Treasurer for the State of California notes general obligation and lease revenue bonds outstanding and supported by the General Fund currently total \$80.8 billion so far this year. At the close of 2019, there was another \$35.7 billion in State Revenue Bond Financing Programs as well as \$31.7 billion in through Conduit Financings with outstanding bonded debt.

In addition to these state supported or issued bonds, add outstanding debt of local government, district, agency, and authority, including all general obligation and revenue bonds. In total, it's estimated some \$482 billion in bonds are outstanding—just over 12% of the total municipal bond market.

That's a lot of investors holding a whole lot of bonds. Morningstar reports that as of March 2020, \$82.9 billion were held in California intermediate and long muni mutual funds. Individual bondholders, separately managed accounts, trust accounts, and other institutional investors hold the balance.

Regardless of where the bonds end up, all that debt is held in a portfolio somewhere. California Governor Newsom's "Stay at Home" order is going to affect every last dollar of it in one way or another.

The order sharpens the focus on the vulnerability geographically concentrated portfolios incur when faced with systemic risk.

### **Diversity Vs. Correlation**

Diversification in a California-only municipal bond portfolio generally means maintaining some geographic dispersion within the state as well as sector heterogeneity.

However, with the public policy response to the coronavirus pandemic affecting the entire state, portfolio diversification becomes far less defensive both on individual holdings as well as, and perhaps even more importantly, the portfolio as a whole.

Credits that initially may have seemed unrelated and uncorrelated are now inextricably connected. Prior to this event, the portfolio may have looked like a well-ordered Venn Diagram. The coronavirus now has those circles converging in ways previously not considered.

### **Defaults Or Downgrades**

Default risk among large public service providers of basic infrastructure, such as mass transit, bridges and highways, municipal services and ports, remain low at this time, in my view. The risk of downgrade, however, is significantly higher.

With downgrades comes not only a decline in pricing but also an increase in volatility. Expand that across an entire portfolio's holdings, even a portfolio with shorter (under 10 year) maturities, and the effect can be substantial.

## **Actions To Take**

There are some specific actions investors should consider taking in assessing the risks this order has heightened, both on individual credits and the portfolio overall.

While perhaps prompted to start these due to the coronavirus, note these are good investment and portfolio management practices that any investor should be doing as part of ongoing surveillance. Appropriate for this time, I draw from the scientist who discovered and promoted vaccination, Louis Pasteur: "Luck Favors the Prepared Mind."

Here is an initial list of several key factors to chart:

1. Revenue Security Source (i.e., ad valorem taxes, sales taxes, fees)
2. Underlying economics of the Security Revenue Source (i.e., home values, sales volume, project or service usage)
3. Backstop Security Provisions (i.e., regulation or legislation permitting or limiting fee increases, release of state support funds, imposition of state oversight)
4. Debt Service Reserve Fund
5. Security Liens (i.e., unlimited taxes, first lien on tax revenues)
6. Number of people served by the service, both directly and indirectly.

While there may be no investment buy or sell to take at this time of market dislocation and illiquidity, I am reminded of another quote. As the proverb goes, "Forewarned is forearmed."

In this market, either quote will suffice.

## **Forbes**

by Barnet Sherman

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