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Managing Risk in WS's Credit-Focused Investment Strategies

Tomorrow is Only a Day Away

December 2018

Introduction

Wasmer Schroeder's (WS) approach to credit risk has been outlined in many of our published pieces over the years. Our philosophy has always been based on the belief that the only way to minimize a portfolio's potential credit problems is to apply fundamental credit analysis to every bond in our approved universe. Credit expertise, rigorous due diligence, and ongoing security monitoring are integral parts of WS's credit process.

Screening Out the Noise

WS's credit-focused strategies require more stringent risk management given our higher bond allocations to the lower investment grade segments of the market. Our credit products have notable allocation to bonds rated 'BBB' and 'A,' with several of them allowing limited allocations to bonds that are rated below investment grade. Municipal bonds in this rating universe still have extremely low default risk but tend to exhibit a higher degree of rating and price volatility.

There is no shortage of opinions regarding this segment of the market, with many industry pundits offering their predictions of doom-and-gloom and severe credit stress for the municipal bond sector (Meredith who?). At times, it is difficult to screen out the market noise. In our view, though, it is more important to be right in the long term than it is to be in line with the consensus in the short term. This abundance of market noise underscores the importance of having both an independent and informed credit process that can differentiate between perceived risk and real risk. In this paper, our goal is to provide insight and specific examples of WS's approach to risk, with a particular focus on our credit-sensitive strategies.

How is Credit Risk Managed in WS's Riskier Municipal Bond Strategies?

WS's most experienced analysts are responsible for the selection and ongoing surveillance of the opportunistic credits that we hold in our credit-focused strategies. Our process requires analysts to focus on "tomorrow" and make the case that our internal rating will likely be maintained under a myriad of future downside scenarios. We underwrite to a zero-loss standard in all of our investment strategies, measuring creditworthiness and default probabilities as integral parts of this process. Our credit-driven strategies account for a wide tolerance of credit volatility. This is because bonds in this universe are typically characterized by higher ratings volatility and financial profiles that are more correlated to changes in the economy. Nevertheless, as long as candidates meet our zero-default probability thresholds and investors are being paid for these risks, these securities can be ideal candidates for WS's higher-yielding products. Investment firms with a heavy credit research focus are best positioned to distinguish between attractively priced, money-good bonds that are often out-of-favor during "risk off" periods, compared to bonds with fundamental and often irreversible credit problems.

Application of this Credit Focus

Below, we highlight two lower-rated credits that provide insight as to how we evaluate credit and risk.

A Tale of Two Credits	
Bond 1	State of Illinois Sales Tax Revenue Bonds (rated 'BBB'/Negative by S&P)
Bond 2	City of Ridgecrest, California, Lease Obligation Certificates (Rated 'A'/Stable by S&P)

The Illinois bond is secured by a statewide sales tax. Despite that level of financial support, WS has maintained a credit opinion that has been several rating levels below S&P for some time. As recently as October 2018, S&P rated this bond 'AA-' but downgraded it to 'BBB' shortly thereafter, which now aligns with WS's longstanding internal rating of 'BBB.' The bonds trade at levels that are closer to our rating, making them attractive candidates for our Credit Strategies.

The City of Ridgecrest is a California municipality with a population of just under 30,000, located 152 miles northeast of Los Angeles. The WS credit research team reviewed this credit for a new offering in November 2018.

Both of these credits are ineligible for WS's high-grade strategies. For the credit strategies, though, we consider other factors such as the following:

– The Illinois Sales Tax bonds are dependent on a continuing appropriation by the Illinois State Legislature. While the appropriation is mandatory with no legal outs, Illinois still has physical possession of the pledged funds for a brief period. Therefore, credit spreads are highly correlated to the credit profile of the State of Illinois, which is the lowest-rated state in the nation at 'BBB-'/Negative by S&P.

– S&P's negative outlook on the Illinois sales tax bond reflects the ongoing budget pressures in the State of Illinois.

– The second bond is secured by the City of Ridgecrest, which is characterized by a poor socioeconomic profile and a history of poor fiscal management.

Based on ratings alone, these two issuers make for a somewhat confusing story for investors who are counting on stable credit ratings. An investor who recently purchased an S&P 'AA- rated' Build Illinois bond prior to November 2018 would now be holding a 'BBB-'rated bond after S&P downgraded it by five-notches on October 30, 2018, after reaffirming its 'AA-' rating just several weeks earlier on October 2, 2018. This action does not mean that the bonds will not pay, but investment firms should be able to identify specific instances when public ratings are vulnerable to downgrade, as a fall in rating is often accompanied by trading volatility and price declines.

Similarly, the City of Ridgecrest has been assigned a solid investment grade rating of 'A'/Stable. In our opinion, however, the bond is overrated based on ongoing economic and budgetary challenges that we believe would be exacerbated in a down economic cycle. In our view, S&P has prematurely upgraded the city in recent years, following modest budget stabilization in the wake of the Great Recession. In 2013, the city was rated non-investment grade and was subject to a "going concern opinion" from its auditor. These examples demonstrate the need for a robust independent credit function.

The Build Illinois Bonds are approved for our credit strategies based on several factors. The securities have exceptionally strong bondholder security provisions, a stable and broadly-pledged tax that encompasses the entire state of Illinois, and a strong payment history despite severe and longstanding budget problems at the state level. The bonds' ratings, however, are tied to the State of Illinois, which tends to cause above-average rating volatility. Conversely, our credit research turned down the City of Ridgecrest bond despite attractive credit spreads, based on the city's very challenged economic base, weak security provisions, a history of local government bankruptcy in the State of California, and the city's poor track record of managing resources in recessionary environments. The fact that the ratings on the Illinois sales bonds are three notches lower than the Ridgecrest lease bonds further underscores our thesis that independent credit analysis trumps public ratings. While both of these credits were underwritten separately, Appendix A provides more insight on how we arrived at our respective credit decisions.

"The good times of today are the sad thoughts of tomorrow." – *Bob Marley*

While perhaps we are not as negative on the future as Mr. Marley, WS's credit view of the fixed income markets is that tomorrow will come with challenges. Consequently, despite the somewhat benign credit environment that is supported by the near 10-year economic recovery, we continue to maintain stringent credit underwriting policies, particularly for WS's riskier credit products.

As recently as October 2018, S&P rated this bond 'AA-" but downgraded it to 'BBB' shortly thereafter, which now aligns with WS's longstanding internal rating of 'BBB.'

Appendix

A Tale of 2 Credits: Factors Determining Credit Eligibility for WS Investment Strategies

Bond Type	State of Illinois Build Illinois Sales Tax Revenue Bonds	City of Ridgecrest, California, Lease Obligation Certificates
Candidate for WS Credit Focused Credit Strategies?	Yes	No, turned down in 2018 by WS Credit Dept.
S&P Rating	'BBB'/Negative	'A'/Stable
Estimated Trading Levels	'BBB'/'BB' Trading Equivalent	'BBB'/'BB' Trading Equivalent
Rating Stability	Generally good rating stability, given already low rating level and low default risk.	Poor rating stability as current public rating is based largely on current credit cycle.
Service Base/Population	12.8 Million	28,000
2017 Unemployment Rate in Core Service Area	5% (Statewide)	9% (Kern County)
Located in a Bankruptcy Eligible State	No	Yes
Resource Available to Pay Debt Service	Annual Statewide sales tax collections covers annual debt service by over 20x	Debt service is paid from its core operating fund but other budget priorities may pressure bond payment over the long term
Security Provisions	Strong: monthly set-aside provisions of pledged sales tax into bond funds are supported by very explicit and enforceable legal provisions	Weak: legal outs for lease payments if lease facilities are not suitable for occupancy
Credit Vulnerabilities	IL Legislature handles pledged funds	Challenged economy and weak management history increase likelihood of budget pressure in a recession
Historical performance Under Stressed Conditions	Bonds have continued to pay during numerous IL budget crises	Poor budget management led to below investment grade ratings and auditor warnings in the last recession
Default Risk	Very low due to exceptionally large, diverse and growing tax base, robust debt service coverage and strong legal provisions that will continue to discourage the state from interrupting pledged revenue flow	Above average due to poor credit history, weak legal provisions and history of distressed local governments in CA defaulting on lease revenue bonds
Recovery after Default/Bankruptcy	Exceptional based on strong legal provisions and bankruptcy ineligibility	Poor based on distressed local government in CA actively pursuing bankruptcy to reduce debt and low historical bondholder recoveries on defaulted CA lease obligations (less than 50 cents on the $)

Reid Tomlin
Senior Vice President, Senior Municipal Analyst

Reid Tomlin holds the position of Senior Municipal Analyst and is responsible for supporting the day-to-day functions of the Research department, as well as establishing and overseeing credit policy for Wasmer Schroeder's (WS) municipal credit function.

Mr. Tomlin earned his M.S. in Financial Management from New York University and is a graduate of the University of California, San Diego. Mr. Tomlin serves as a board member for the Southern Municipal Finance Society, and Sailing Heals, a 501(c)(3) non-profit organization. In addition, he is a member of the National Federation of Municipal Analysts, the Municipal Analysts Group of New York, and the CFA Society of Naples.

About the Firm: More than 30 years ago, Wasmer Schroeder was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income the right way. From its beginning, the firm has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions for whom we manage money. We do right by doing right by them—knowing their businesses, understanding their goals, and consistently finding solutions to meet their needs. As an active fixed income manager with a team of investment professionals across tax exempt and taxable strategies, we are dependable, collaborative, and insightful in our approach. Backed by research and emboldened by technology, our hands-on team is a true partner to the advisors, investors, and institutions who give us their trust.