

Importance of Local Municipal Credit Analysis

Municipal credit research is at the forefront of AHB's investment process. Thoroughly understanding each security in a portfolio is integral to our philosophy. We invest in local municipalities throughout the country and an important portion of our research concentrates on how funds are distributed from the state level to local municipalities.

How does a state's overall financial position affect local municipal credit?

As some states make headlines for their underfunded pension liabilities, we believe there are both opportunities and pitfalls to navigate.

Credit:

From a credit perspective, this question is important for municipalities in lower rated states and significant to states throughout the country. On a national average, individual school districts (K-12) rely heavily on state aid, with approximately 45% of school revenues coming from funds at the state level and another 10% from the Federal government. Each state determines how funds are distributed to each municipality, but typically a greater allotment is distributed to lower income areas, which have less ability to raise funds from property taxes. Since schools rely so heavily on state aid, cuts to state funding generally force local school districts to scale back educational services, or put additional financial pressure on local governments.

Growing pension and other retiree costs will limit a weaker state's ability to support public education. States will face an increasingly difficult spending choice - between paying for education related retirement benefits and providing funds/resources to school districts. Districts that rely heavily on state aid are most vulnerable to spending cuts.

AHB's Take:

States like New Jersey, Connecticut and Illinois with poor financial positions at the state level paint a negative picture of the credit worthiness of the entire state's municipalities. Even with these challenges at the state level – Local education is the highest priority for residents of a community. Each municipality will make every effort to maintain the quality of their school system - which helps preserve local property values. AHB believes that there are opportunities in these states to find financially strong local municipalities (that aren't over-dependent on state funds – and have an impetus to maintain quality) with relatively attractive yields that may be discounted for missteps at the state level. There are opportunities for additional return within less favorable states for Investment Grade Municipal Bonds with the proper credit analysis.

At, Abner Herrman & Brock we focus on uncovering attractive risk/reward investments for our clients, and put credit research at the forefront of our decisions. Understanding each security in a portfolio is integral to our philosophy.