JANUARY 2025

WHAT ARE US MUNICIPAL BONDS?
CASE STUDIES

INTRODUCTION

In our experience, for many investors outside the US, the municipal bond market remains an underappreciated asset class. Foreign ownership of municipal bonds is just 2.9%, versus around 28% for US corporate debt.[1] In part, we believe this disparity is primarily due to the market's relatively complex nature. Despite being 40% of the size of the US corporate bond market,[2] the number of issuers comprising the municipal bond market, over 59,000, is eight times greater than the equivalent number of US corporate issuers.

US municipal bonds explained

US municipal bonds, also known as muni bonds or munis, are bonds issued by agencies and authorities of US states, cities or local government bodies. They can take the form of general obligation (GO) bonds, funded via tax revenues, or revenue bonds, secured by an income stream from a specific local infrastructure asset. Historically, this has meant that default rates have been low,[3] making munis an attractive investment for risk averse investors, and a way to diversify corporate bond holdings.

The fragmentation of the US municipals market means there are potentially considerable opportunities for active managers to exploit, we believe. However, these characteristics require detailed credit analysis by a specialist team to truly understand each bond issue. For revenue bonds, this means undertaking painstaking analysis to assess the unique risks and characteristics of the underlying infrastructure assets underlying each instrument. The examples below are issuers we have at one time held, currently hold or taken an active decision to not hold. The examples used are for illustrative purposes only and are not investment recommendations.

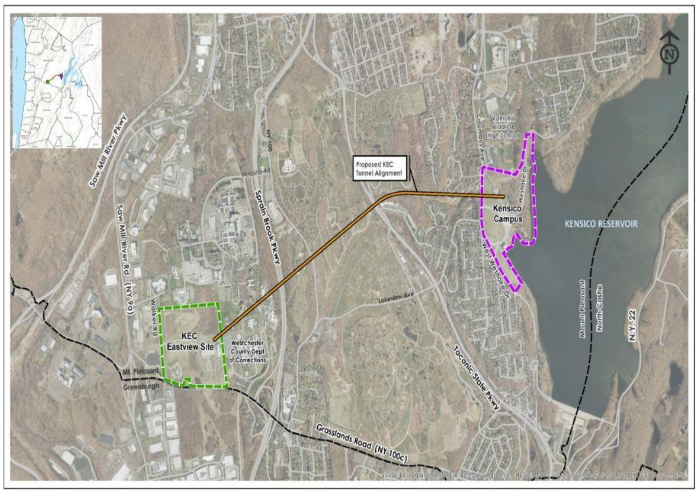
CASE STUDY 1: NEW YORK CITY MUNICIPAL WATER FINANCE AUTHORITY

Background

The New York City Municipal Water Finance Authority (NYW) has responsibility for financing the capital to maintain New York City's water and sewer system by issuing bonds, commercial paper and other debt instruments. The Authority aims to maintain the quality and delivery of over 4.5 billion litres of drinking water to New York City every day. The issuer uses the proceeds raised from its bond issues to fund the maintenance of New York City's watersheds, which comprise over 19 reservoirs and three controlled lakes across 2,000 square miles. In doing so, NYW ensures water supply to New York City complies with federal and state water quality standards.

Example of projects funded

Figure 1: Kensico-Eastview Connection map[4]



The Kensico-Eastview Connection is a 3.2-kilometre (2 mile) long water conveyance tunnel currently under construction in New York state between the Kensico Reservoir, a reservoir 15 miles north of New York City that supplies the city with water, and the Catskill Delaware Ultraviolet Disinfection (CDUV) Facility, the world's largest ultraviolet treatment plant. The project began in July 2024, with all phases of its constructions expected to span a 10-year period before it becomes fully operational in 2035.

The CDUV facility's primary function is to treat water specifically for cryptosporidium and giardia, naturally occurring microorganisms that can be found in surface waters and can cause gastrointestinal ailments. The tunnel will bring water to the facility's 56 UV units, which neutralize those bugs.

[1] Source: Federal Reserve Board Flow of Funds; firm data as at 30 June 2024. Universe is all of the municipal debt outstanding. Data is on a lag due to availability
[2] Source: SIFMA as at 30 June 2024. Data is updated on a quarterly basis and on a lag due to data availability
[3] Source: Moody's Investors Service as at 19 July 2023 Average Corporate Debt Recovery Rates for senior unsecured bonds 1970-2022.
[4] Source: City of New York, as at August 2023

The tunnel will, once finished, will have a diameter of 27 feet and installed between 400 to 500 feet below ground and will convey 2.6 billion gallons of water a day between the reservoir and the CDUV facility.

How the issuer services its bond issuance

The issuer services its debt via the revenues generated by water rates, fees, rents and other charges for water supply, treatment and distribution, and sewage collection, treatment and disposal for New York City residents.

CASE STUDY 2: CHICAGO O'HARE INTERNATIONAL AIRPORT

Background

Chicago O'Hare International Airport is a major international airport located in Chicago, Illinois and is one of the largest airports in the world. The location of the airport means it is considered the most connected airport in the United States and fifth most connected globally. As of 2024, the airport has non-stop flights to 249 global destinations.

Example of projects funded:

Figure 2: Chicago O'Hare Airport[5]

The O'Hare Modernisation Program (OMP), beginning in 2005, is a long-term redevelopment of Chicago O'Hare that aims to improve the passenger experience of the airport. In that vein, the OMP sought to increase efficiency by expanding the airport's capacity to ease congestion and prevent flight delays. The Federal Aviation Authority highlighted the scale and ambition of the project describing it as "one of the largest and most costly reconfigurations of an airport in the United States".

The key component of the modernisation programme is renovating and reconfiguring the airport's runways, moving from an intersecting runway configurating to a parallel runway system, necessitating the construction of three new run runways and the reconstruction of a fifth.

More recently, issuance by Chicago O'Hare has focused on terminal redevelopment and additional capacity enhancements. For example, as part of the modernisation plan the airport two existing terminals will be reconstructed or expanded, while a new global terminal is under construction for international arrivals.

How the issuer services its bond issuance

The issuer services its revenue bond issuance via the income generated by economic activity at the airport, including terminal rents and landing fees paid by airlines, parking fees paid by passengers and concession revenues from vendors operating within the airports limits.

CASE STUDY 3: ALAMEDA CORRIDOR TRANSPORTATION AUTHORITY (ACTA)

Background

The Alameda Corridor Transportation Authority (ACTA) operates a freight rail 'expressway' which connects containerised traffic arriving at the San Pedro port cluster. The San Pedro port cluster is the most important in North America in terms of volume and value, accounting for about 70% of containerised traffic arriving on the American West Coast.

Example of projects funded

The railway corridor was built to ensure the efficient transportation of goods entering the United States via the Ports of Los Angeles or Port of Long Beach to transcontinental railway terminals in the City of Los Angeles, the two largest in the US.

Historically, transporting freight between railyards could reach between 2 and 6 hours; by contrast, after the corridor's completion the average time taken for containers to reach the terminal railyards has fallen to 45 minutes. In addition, the railway also enabled eased local road congestion by removing 200 existing rail crossings associated with the previous, circuitous routes, which ran through local communities.

Since the expressway's completion early 2002, ACTA's bond issuance is primarily used to maintain the expressway and refinance its outstanding debt.

[5] City of Chicago, as at January 2025

Figure 3: Map of the Alameda rail corridor [6]

How the issuer services its bond issuance

ACTA primarily generates revenues via usage and container fees paid by the corridor's primary users, which include major railroad companies BSNF Railway and Union Pacific Railroad. ACTA can increase these rates annually, increasing prices by between 1.5% and 4.5%.

In addition, if revenues generated from these sources prove insufficient to meet the issuer's debt service, the Port Authority of Los Angeles and the Port Authority have a contractual obligation to make up any shortfall up to 40% of the issuer's annual debt service.

CASE STUDY 4: BUILD AMERICA BONDS - WHY ACTIVE MANAGEMENT MATTERS

Background: financing infrastructure after the financial crisis

Build America Bonds (BABs) are municipal bonds issued between 2009 and 2010 to encourage investment in state, municipalities and counties in the aftermath of the financial crisis. The BAB program raised over $180bn of taxable municipal bonds to finance infrastructure-related projects across the US.

Under the BAB program, state and local governments issued higher-yielding taxable bonds instead of the normal tax-exempt bonds. In exchange for paying the higher interest rates, issuers were to receive 'BAB subsidy payments' from the federal government equal to 35% of the interest payments on the bonds.

In 2012, Congress enacted a law which required reductions of certain government spending, resulting in the reduction of the BAB subsidy payments in varying annual amounts through 2031.

In addition, most BABs contain an optional 'Extraordinary Redemption Provision' (ERP) allowing for the bonds to be called by the issuer under an extraordinary event, which is defined in varying degrees from deal to deal. According to Barclays, up to $110bn in outstanding BABs have embedded ERPs, out of around $180bn in total.

Analysis: risks realised in 2024 lead Build America Bonds to underperform

Given the subsidy reduction and ERP option, Insight considered the risks of investing in BABs too high, and we never purchased any BAB issues. We believe this decision enabled us to protect our clients: until 2024, the exercise of an ERP was very rare, but in 2024 alone, $14.9bn of BABs issues were called[7], with an additional $938m remaining to be called. As a result, many BABs are now trading near their ERP strikes, and spreads relative to non-BAB taxable municipal bonds have widened dramatically.

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[6] The Alameda Corridor Transportation Authority, 2010.

[7] JPMorgan, 31 October 2024

Why Insight for US municipal bonds

Having launched one of the first overseas infrastructure U.S. municipal bond strategies in 2017, the munis investment team at Insight Investment understands the varying needs of its global base of investors.

Highly experienced specialist munis team

In our view, considerations and lower daily liquidity, requires demonstrated expertise. Insight's highly experienced municipal investment and trading teams have operated through multiple market and business cycles, providing the ability to navigate these idiosyncrasies, maximise the opportunity set and harness the unique attributes of revenue bonds.

Ability to exploit opportunities in a fragmented market by a specialist team

The fragmented nature of muni bonds and infrastructure projects financed, and a buyer base dominated by retail investors, provides a distinct opportunity to exploit market inefficiencies. Detailed credit analysis by a specialist team is required to identify and assess the unique risks and characteristics of the underlying infrastructure assets and how they are being managed.

Revenue bond focus

We believe revenue bonds possess several advantages over general obligation bonds, such as strong credit fundamentals, greater insulation from political risk and historically attractive yields. We believe these characteristics, in combination with a focus on high-quality, stable issuers in economically strong services areas, represent bond income sources that are better insulated from economic slowdowns than tax-reliant general obligation (GO) bonds.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialise or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due. The return risk to a portfolio is higher where a portfolio is highly concentrated in such an issuer.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Leveraged funds: as a result of market conditions, the value of the assets held by a Fund may fall and result in a higher degree of leverage than is deemed appropriate by the Investment Manager. In order to reduce the degree of leverage, the Investment Manager may seek to reduce a Funds' total asset exposure. Investors would need to subscribe for additional Shares in order to maintain the level of sensitivity to market movements. Where such an event is unanticipated, this may result in the investors having less sensitivity to market movements than they might consider appropriate to their individual requirements until they have subscribed for additional Shares

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