A Tale of Two Bonds: The Role of Investment Grade Fixed Income in a Portfolio

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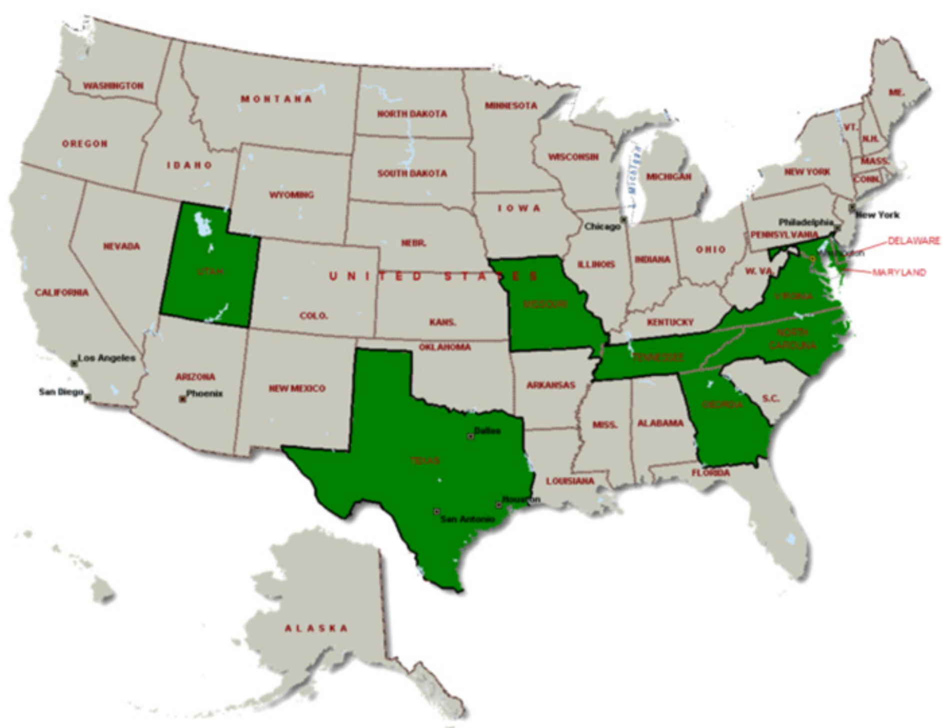
Thursday, May 26, 2016 was a "Triple A" day for Tennessee General Obligation (GO) Bonds. It is the day that S&P upgraded the state's debt rating from AA+ to AAA, making Tennessee one of nine states with the highest quality rating from all three major credit rating agencies – Standard and Poor's Global Rating Services, Moody's Investor Services, and Fitch Ratings. The reasons given for the rating uptick, which affects $1.96 billion in outstanding bonds, were Tennessee's improving economy, growing reserves, and sound management. According to the Tennessee Comptroller, Justin P. Wilson, "Tennessee has one of the lowest debt burdens in the country and our elected officials are committed to living within our means." This is good news for Tennesseans because the state can borrow at lower interest rates. It is also good news for bondholders who depend on a return of their principal and the continuance of their interest payments.

Nine States Have AAA Bond Ratings by S&P, Moody's, and Fitch



Source: Vining Sparks Fixed Income Capital Markets as of August 3, 2016

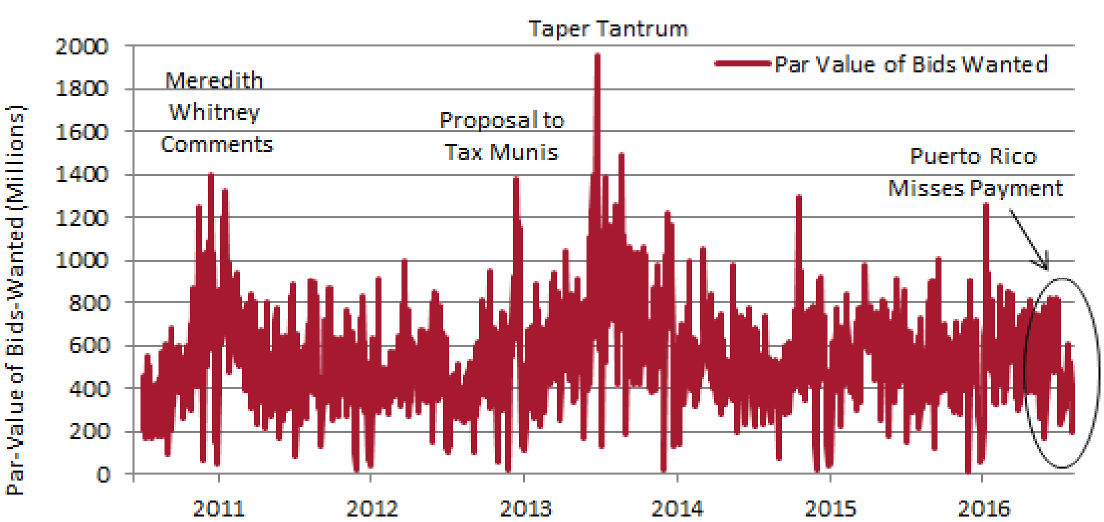
Sound fiscal management and bond credit quality are important; just ask the many investors who hold Puerto Rican debt. In contrast to Tennessee, Puerto Rico unwisely continued to issue bonds to cover essential services in the face of declining governmental revenue. The population of the island began declining in 2006 as residents left to seek higher paying jobs offshore and yet the government continued to use debt to finance essential services. The debt load has doubled to $72 billion since 2008. That is $20,000 of debt per resident! The result of the fiscal mismanagement is Puerto Rico's default on nearly $1 billion of principal and interest payments on July 1, 2016 and more defaults likely to follow. This is the first time since 1933 that a state or territory has defaulted on debt. One day prior to the default, President Obama signed the Puerto Rico Oversight, Management and Economic Stability Act (PROMSEA) bill into law, delaying bondholders from suing and creating an oversight board to help work through the financial crisis. The probable outcome will be bondholders will wait longer than expected to receive their principal or get less money back. Many of the island residents who bought the bonds for income are delaying retirement plans or are retirees who now have to return to work.

Truxton Trust Wealth Management clients had no exposure to Puerto Rico bonds in their portfolios.

The Puerto Rican default has not negatively impacted the broad investment grade municipal bond market. Selling interest in municipal bonds has actually dropped since the Puerto Rican default (see chart below). In fact, investment grade bonds, including municipal bonds, rallied strongly as investors flocked to high quality assets following United Kingdom's surprise July vote to exit the European Union. More importantly, like Tennessee, the financial health of many municipal bond issuers across the United States has improved in tandem with the broad economic recovery in the United States, insulating these credits from Puerto Rican worries. While there are notable exceptions to improvements in credit quality, municipal bonds remain in strong demand as investors seek one of the few tax-advantaged investments available.

As was the case with Puerto Rican debt, continual monitoring of creditworthiness is important. The credit rating provides a guide to the investor. S&P, Moody's, and Fitch are frequently reviewing the financial status and outlook for entities issuing debt

Municipal Market Unfazed by Puerto Rican Default



The chart measures the amount of par (face) value of municipal bonds actively being marketed for sale (known as "Bids Wanted") by market participants. Increases in Bids Wanted represent an increased interest by market participants to sell their municipal bond holdings.

Source: Bloomberg as of 8/4/16

and assigning ratings based on their findings. The range of data considered in their evaluations includes sources and stability of revenue, demographics and fiscal growth of the community or company, amount of debt outstanding, accounting principles, management, and long-term liabilities such as pension benefits. The resulting credit rating ranges from AAA (the highest rating) to D (default).

The interest rate environment, both domestically and abroad, remains challenging for income-oriented investors as global economic conditions have led to ultra-accommodative monetary policy responses by central banks designed to push interest rates to abnormally low levels. As a result, many investors, in their quest for enhanced yields, have migrated toward below investment grade bonds. Truxton Trust buys high quality bonds rated A or better. In doing so, we have great comfort that we will avoid situations like Puerto Rico where investors were reminded of how quickly and harshly "return of principal" considerations can eclipse "return on principal" considerations. Below investment grade corporate and municipal bonds, like stocks, come under pressure in periods of economic weakness and financial stress. In extreme conditions, their correlations spike, limiting one of the primary benefits of bonds in a multi-asset class portfolio – diversification against stock market volatility. We continue to view investment grade fixed income as the most cost effective and time tested tool to buffer equity market volatility. Our philosophy is that a balanced portfolio of stocks and individual high quality bonds will create a portfolio with less volatility and solid returns over time. ■

Debt Ratings Defined

Investment Grade

AAA: Highest credit quality. 'AAA' ratings denote the lowest expectation of credit risk. It is unlikely that this issuer would be adversely affected by foreseeable events and is assigned only in the case of exceptionally strong capacity for timely payment of financial commitments.

AA: Very high credit quality. 'AA' ratings denote a very low expectation of credit risk. This issuer would not be significantly affected by foreseeable events and indicates a very strong capacity for timely payment of financial commitments.

A: High credit quality. 'A' ratings denote a low expectation of credit risk. The issuer may be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings. The capacity for timely payment of financial commitments is considered strong.

BBB: Good credit quality. 'BBB' ratings indicate that there is currently a low expectation of credit risk. The issuer could be impacted by adverse changes in circumstances or in economic conditions but the capacity for timely payment of financial commitments is considered adequate. This is the lowest investment-grade category.

Speculative Grade

BB: Speculative. 'BB' ratings indicate that there is a possibility of credit risk developing. The issuer is vulnerable to adverse economic conditions; however, business or financial alternatives may be available to allow financial commitments to be met.

B: Highly speculative. 'B' ratings indicate that the issuer has significant credit risk a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment.

CCC, CC, C: High default risk. Default is a real possibility. The issuer's capacity for meeting financial commitments is contingent upon sustained, favorable business or economic developments. A 'CC' rating indicates that default of some kind appears probable. 'C' ratings signal imminent default.

DDD, DD, D: Default. The ratings of obligations in this category are based on their prospects for achieving partial or full recovery in a reorganization or liquidation of the obligor. 'DDD' obligations have recovery, around 90% - 100% of outstanding amounts and accrued interest. "DD' indicates potential recoveries in the range of 50% - 90% and 'D' has the lowest recovery rate - below 50%.

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