



SEPTEMBER 2018 NEWSLETTER



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How can an Investor Buy Municipal Bonds in a Rising Interest Rate Environment?

By Carolie Smith, *Vice President, Institutional Sales*

Now that interest rates are clearly on the rise, how can an investor buy municipal bonds? There are certain structures to look for and overall considerations to make before deciding what bond is right for you.

First, most individual municipal bond buyers do not buy bonds to make a profit. The main reason most investors buy muni's is to preserve their principal, and therefore, keep pace with or stay ahead of inflation.

Here are a few things you might want to consider as rates continue to rise:

• Buy Callable Bonds

You may choose to buy callable bonds, as long as the yield to the call date is higher than the yield for non-callable bonds that mature on the call date. For example, if you buy a bond that matures in 2026 which is callable, make sure that the yield to the call date is higher than a non-callable bond in the same year. This allows you to own bonds with a higher rate to the call date and most of the time the rate will be higher to maturity. This is called a 'kicker' bond because the 'kick' to the final maturity is higher than non-callable bonds. Callable bonds can yield 10-25 basis points higher than non-callable bonds.

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Example:

Non-Callable: Pacific Grove CA – 4.00% due 2027 - 2.35% YTM Offered at \$113.142

Callable: California State Public Works – 5.00% due 2026 - 2.556% YTM 2.25% YTC (2025) Offered at \$116.829

• Buy Shorter Maturities

You may consider buying shorter maturity bonds in this environment. As bonds mature, you can reinvest at the new higher rates and try to stay with or beat inflation. Buying shorter maturities will also result in a shorter duration, which measures interest rate risk. This could be a positive for your overall portfolio. For every 1% interest rate increase, your bond price will move either up or down. If rates move higher by 1% (100 basis points), and your duration is 5, then the price of your portfolio will be lower by 5%. For every 1% change in interest rates, the price changes (1 X duration).

• Buy fewer High Yield Bonds

As rates increase, the spread for lower rated bonds will widen. Over the past five years, investors have been 'reaching for yield'- which means they have been discounting the credit quality of a bond in order to obtain a higher rate of return. As interest rates rise, the market will differentiate more between 'below investment grade' bonds (Not-Rated – BB) and 'investment grade' bonds (AAA-BBB) bonds. It's important to understand that the prices for High Yield bonds, which are speculative investments, will deteriorate quicker than Investment Grade bonds. The spread will widen between the two credit types of bonds as interest rates rise.

As of the date of this article (9.20.18), Fed policymakers were widely expected to raise interest rates later this month and have also penciled in a fourth move this year, though a more persistent slowdown in inflation could affect their outlook.

Government Treasuries currently are:

2 years: 2.80%
5 years: 2.95%
10 years: 3.06%
30 years: 3.20%

Contact your representative at Alamo Capital for more information :

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Distressed Bond Information: Daughters of Charity Health System

On August 31, 2018 Verity Health (which had taken over Daughters of Charity Health System) filed for Chapter 11 Bankruptcy in California. The non-profit, now owned by billionaire Patrick Soon-Shiong, has stated that they will continue providing services throughout the bankruptcy/restructuring, but that they intend to sell some or all of its assets.

The non-profit has about \$461.4 million of secured municipal debt, part of \$500 million in long-term liabilities. If you are a bondholder, please note these bonds are:

- Senior Secured Bonds - Master Indenture - the bondholders have first priority Lien on any Property, Plant and Equipment. This is a 'Secured' position, similar to a 1st Mortgage-type securities
- They are Net Revenue bonds, with a 110% net revenue pledge
- Currently the Health Facilities are Not for Profit organizations, if sold or transferred to a 'For Profit' institution, bondholders must be paid
- Nuveen owns approximately 25% of the bonds
- UMB was just appointed 'Master Trustee' on Sept 4th and has extensive experience with 'workout issues' such as this
- Hospitals in this group have been for sale the past two years, and there are interested buyers

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