Gurtin Municipal Bond Management

Municipal Credit Research Report

Detroit: The Latest Example of Why We Diligently Seek to Avoid Credit Distress

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Executive Summary

Gurtin Municipal Bond Management's philosophy has always been to avoid credit distress, and we achieve this by pro-actively managing investments with forward-looking research. Recent incidents in California and Michigan illustrate just a few examples of credit distress in the market.

Detroit's bankruptcy proceedings have highlighted that some managers appear to be relying exclusively on the perceived strength of a bonds' security and ignoring the reality of an obligor's true credit quality and its ability to fulfill its obligations, or even worse, placing their faith in State governments to step in and protect bondholders.

The uncertainty and chaos that follow credit distress reinforce our approach as once obligors enter distress, investors' exposure to the associated risks is exponentially heightened. This is why we avoid credit distress.

We believe fundamental credit analysis at a granular level is critical to avoiding credit distress and protecting our clients' interests. This is how we avoid credit distress.

High quality obligors in the State punished by the actions of other may present future investment opportunities.

Gurtin Municipal Bond Management's research philosophy has always been to avoid credit distress, and we achieve this by pro-actively managing investments with forward-looking research. Local governments in California and Michigan have provided several recent examples of credit distress

Through the years, we have mentioned our research philosophy of avoiding "credit distress", and with Detroit's bankruptcy proceedings we believe it is a good time to remind clients of this concept given that the troubled City serves as a good example of credit distress and the benefits of avoiding it.

Detroit's distress should not surprise anyone; for decades, the City has been plagued by numerous red flags and Gurtin Municipal Bond Management has avoided the City's debt since our firm's inception

The City of Detroit has long been on the path of credit distress, and we have viewed the City's ultimate bankruptcy filing as an inevitability. Given decades of precipitous population declines, intensified by industry losses, and years of structural imbalance coupled with governance concerns, the City's ability to regain fiscal control became a challenging and nearly an impossible feat outside of a bankruptcy filing. The figures alone speak for themselves; the City has sustained a 60% population loss in 60 years, property valuations have been reduced by 46% between 2007 and 2012 alone, and the City's General Fund has had a negative fund balance for the last 8 consecutive years that grew nearly three-fold in 2012 to negative $270 million. Partially exacerbating the City's weak credit profile is its long-term liabilities, especially as they relate to pension benefits. The current retirees collecting pension benefits from the City far outweigh those paying into system, and the City is losing active, contributing members at an alarming rate. Under the growing burden of debt and an extremely out of balance budget, the State eventually appointed an emergency manager after determining the City's management was incapable of effectively rescuing the City from its fiscal troubles. By the time the emergency manager took over in March 2013, the inaction of the City's management team had damaged the City's finances to a degree that despite being granted with broad powers, the emergency manager determined that only an aggressive restructuring proposal would resolve the City's fiscal problems. However, after the restructuring negotiations fell through, the City of Detroit became the largest U.S. city to file for Chapter 9 bankruptcy protection.

Credit distress signifies the beginning of an unpredictable journey that Gurtin Municipal Bond Management has no appetite to undertake

Once an obligor enters credit distress, their credit quality begins a highly unpredictable and risky journey, and we do not believe it is in the best interest of our clients to subject their portfolios to undue risk as this journey unfolds. Our independent research has revealed that distressed obligors are at heightened risk for credit events (defaults or bankruptcy protection). As a result, we seek to avoid obligors that have trajectories suggesting the potential for future distress, as well as, immediately exit positions in obligors that are nearing distress. It is important to note that distress does not mean default; however, it is a very common precursor. The consequences of credit distress have dominated recent headlines as evidenced by Detroit's bankruptcy filing, several bankruptcy filings in California and defaults by two Michigan school districts. No two scenarios are exactly alike, there is no script on how obligors find themselves in distress, nor is there a handbook on how distress is eventually resolved. Detroit, Stockton, and San Bernardino have become commonplace names associated with the default and bankruptcy actions. However, long before they were in the headlines, the use of thorough credit analysis would have uncovered clear and unmistakable indicators of distress.

Detroit's perilous circumstances highlight that some managers appear to be relying exclusively on the perceived strength of a bonds' security and are ignoring the reality of an obligor's true credit quality and its inability to fulfill its obligations, or even worse, placing their faith in State governments to step in and protect bondholders

We have been shocked to see a wide variety of statements in the press from market participants that suggest their investment decisions have been made without any fundamental research into an obligors' credit quality or a true understanding of the realities of credit risk. Those managers that chased higher yields by holding the City of Detroit's debt are now learning a hard lesson about the need for fundamental research and the folly of ignoring the ample harbingers of disaster. As a result of the bankruptcy proceedings, investors who currently hold Detroit's bonds are unable to determine exactly how much they will eventually be paid, although they have been quite vocal in the press about their expectations. Some bondholders expected priority treatment because of the type of legal security pledged by the bonds they hold, while others expected the State to step in on behalf of the bondholders despite it having no legal obligation to do so. Interestingly, we read similar quotes from managers who were confident that the State of Michigan would step in and enforce bondholders' rights in the case of two Michigan schools that recently defaulted. Again, the State has no obligation to do so and we believe managers who are reliant on this sort of outside help (which includes bond insurance) either did not understand the securities that they held or have made a conscious decision to risk their clients' principal on what is nothing more than a hope of state intervention.

All of these concerns can be avoided by simply avoiding distressed obligors to begin with. We have long opined that legal security becomes irrelevant when the obligor's fiscal profile simply cannot support the debt; insolvency tends to challenge conventional wisdom. Detroit's general obligation unlimited tax debt and the legal expectations of what an unlimited property tax pledge means are moot points when the city can only collect 53% of its billed property taxes, has a rapidly declining tax base, and has sustained a critical mass of population loss. The City will have to reach a resolution to free itself of its obligations and it is very likely that it will result in significant creditor losses.

Most recently, the City was ruled eligible for protection under Chapter 9 bankruptcy with the judge noting the possibility of pensions being impacted as a means to resolve the City's fiscal distress. There remains a high degree of uncertainty in these proceedings and an elevated likelihood of continued legal challenges over an extended period of time. As the City establishes an exit plan, bondholders will be left in a holding pattern with the uncertainty of their recovery rates and where they will fall in the priority of payments. At Gurtin Municipal Bond Management, we are committed to protection of principal, and we believe the most effective way to serve our clients is to avoid this credit risk and uncertainty altogether.

The uncertainty and chaos that follow distress reinforces our approach. Once obligors enter distress, investors' exposure to the associated consequences is exponentially heightened. This is why we avoid credit distress.

Further complicating matters is the multitude of credit opinions and strategies attempting to provide expert guidance on how to investors should deal with credit distress. Because there is insufficient established precedence and tremendous uncertainty associated with distress, many managers subject their clients to a considerable amount of consternation. While these managers may feel vindicated when the risky securities they hold avoid credit events, there is no way they could have been truly confident in the eventual outcome. The lack of predictability is why we avoid it altogether. Gurtin Municipal Bond Managmenet believes anyone professing certainty about recovery rates on Detroit's debt or how events will eventually unfold is doing little more than carnival barking.

There are obligors that drift into distress over an extended period of time, such as Detroit, and others for which it happens in a more precipitous manner. In both cases once the distress threshold has been crossed, uncertainty becomes the rule. Our research philosophy emphasizes very low tolerance for uncertainty because it is typically accompanied by only modest upside and very significant downside risk. In the most severe of cases, distress leads to insolvency and extraordinary uncertainty that results in investors holding bonds for which there is no market. Ultimately, when an obligor crosses into credit distress, investors effectively lose control of the situation and are typically faced with illiquidity. Unfortunately, this is the very situation that holders of Detroit's bonds are facing right now.

We believe fundamental credit analysis at a granular level is critical to protecting our clients' interests and avoiding downside risks. This is how we avoid credit distress.

It is not by mere luck or happenstance that Gurtin Municipal Bond Management has avoided the debt of the now infamous group of obligors that we have discussed. Rather, rigorous credit research at the individual obligor and security levels is the critical component that allows us to avoid credit distress. Before purchasing an obligor's debt, we perform an exhaustive analysis of the security being pledged to bondholders and also thoroughly examine the obligor's overall health and future trajectory. However, the pledged security alone should not provide the basis for investment as is demonstrated in the case of Detroit and its general obligation unlimited tax debt. We believe that credit analysis that focuses on a holistic view of an obligor's health will provide the bondholder the protection necessary to avoid a distress scenario. This granular analysis and our frequent surveillance allows us to identify early warning signs of distress and more importantly, to exit positions before any credit distress occurs.

Conclusion

Gurtin Municipal Bond Management's strict buy and sell disciplines, commitment to fundamental analysis, aggressive surveillance and our emphasis on quickly exiting positions of weakening obligors have enabled us to avoid any exposure to the distressed obligors that dominate the market's attention. Our research philosophy of exclusively investing in very high quality credits and avoiding distress will continue to take precedence in our investment decisions. While other managers may look to distressed obligors as opportunities to boost yield, we will continue to view the immense downside risk that comes with the uncertainty of distress as unacceptable for our clients' portfolios. Our thorough research can help us not only continue to avoid pitfalls and obligors heading towards distress, but also unlock opportunities by finding high quality obligors that are punished for the actions of entirely unrelated obligors.

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