Municipal Market Comments 🔼 🖳



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A Closer Look at the Threat of "Superdowngrades"

A recent article in *Investment News* highlighted a potential risk to the municipal market that some analysts see arising from the provisions of the **Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010** ("Dodd-Frank"). The article describes the potential for an increase in the number of "superdowngrades" of municipal bonds – that is, a rating action which lowers an issuer's rating by one or more full rating categories. Some analysts believe that Dodd-Frank's provisions requiring more frequent review of rating methodology could drive a significant increase in such multi-notch downgrades. While such rating changes would have been insulated in the past by the presence of bond insurance on much of the municipal market, the demise of triple-A bond insurance leaves investors more exposed to the impacts of such rating changes.

We do not believe that we are likely to see any significant increase in the frequency of "superdowngrades" in the municipal market as a result of Dodd-Frank. In the past, methodology adjustments by the rating agencies have generally resulted in much less significant changes in ratings – one or two notches, at most, for credits in affected sectors. Furthermore, an acceleration of the timeframe for rating and methodology reviews should not, in our view, create a higher likelihood of multi-notch downgrades. In fact, we believe the opposite may be true. By increasing the frequency of methodology review and credit reviews for individual issuers, the rating agencies are less likely to encounter situations where there have been substantial changes since the last "look" and therefore will be less likely to feel compelled to make unusually large rating adjustments.

The example presented in the *Investment News* article was the downgrade of De Kalb County, GA by S&P. The County's general obligation (G.O.) rating from S&P was AAA until January 2011, when it was downgraded to AA-. It was subsequently "superdowngraded" by S&P in March 2011, to BBB from AA-. The County continues to carry a Aa3 rating from Moody's after being downgraded twice by that agency, in April 2010 (to Aa1 from Aaa) and December 2010 (to Aa3 from Aa1). The De Kalb example shows that very large declines



in credit ratings tend to have unique circumstances that typically involve poorly disclosed financial pressures, delays in financial reporting that obscure financial distress, or poor management decisions that create substantial declines in financial health. In De Kalb's case, the County posted a series of net deficits in fiscal years 2007, 2008 and 2009 resulting from revenue shortfalls and failure to manage general fund expenditures and transfers. The resulting deterioration of the County's financial position and failure to provide information and financial strategies to the rating agency in a timely manner precipitated the S&P actions.

De Kalb County is typical of the "superdowngrades" that we have seen over the years. Issuers typically show declining financial performance and a failure to implement budget strategies over a period of multiple years. Usually, credit metrics fall well below the rating level on the bonds but are held steady in anticipation of management action to reverse the declines and institute sustainable improvement in financial position. Finally, there is a trigger event – a particularly poor fiscal year result; an unforeseen revenue or expense shock; a delayed audit; etc. – that results in a multi-notch or multi-category rating change. These types of events are quite rare, though, and we expect them to remain so. Much rarer is the type of "Orange County" event that is completely unforeseen until it impacts ratings. Such situations usually result from poor or fraudulent financial reporting that obscures the real picture. They can also be triggered by legal or regulatory shocks that change the fundamental security structure for bond holders or threaten the viability of a project or issuer.

Investors can insulate themselves from the vast majority of this type of "superdowngrade" risk. Our investment approach at Ascent seeks to minimize the potential for such events through careful fundamental analysis of all of the bonds that we purchase:

- We do not buy bonds on the basis of "stale" ratings. We strongly prefer that all bonds that we buy have current rating agency commentary and analysis.
- In every case, we review current financial information. If an issuer has not filed updated financial information or we cannot get an accurate view of the current financial and credit picture, we will not buy the bonds.
- We always look through credit enhancement whether bond insurance or state
 enhancement programs to evaluate the underlying credit quality of the issuer itself.
 We only buy bonds from issuers that we judge as high quality underlying obligors.
- We underweight market sectors that are subject to above-average likelihood of regulatory, legal or event risk.
- When we see deterioration in the credit fundamentals of a bond we own, we make every effort to sell bonds before they reach a point where substantial downgrades become more likely.



No portfolio can ever be completely protected from negative credit events. There will continue to be "superdowngrades" in the municipal market, some off which may be extremely hard to foresee by investors. However, the lessons of De Kalb County, GA, Harrisburg, PA, Jefferson County, AL and many others over the years have been that careful diligence in the investing process and in portfolio surveillance can identify and avoid many credit problems long before they get to "superdowngrade" severity.

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