BONDS

Scarsdale Investment Group, Ltd.

All Bond Portfolios

Buy Muni Bonds: Don’t Delay Cash Flow Creation

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Are you afraid to invest because of feelings of uncertainty about the future? Whatever time we live in appears to be tumultuous. This is especially so with the advent of 24-hour worldwide reporting of the most difficult and terrible situations. We have lived through financial crashes, wars and environmental devastations. We quarrel with each other, yet we survive.

So, What about the Future?

No one knows what the future will bring. As Yogi Berra said, it is hard to make predictions, especially about the future. We agree with Yogi.

That said, doing nothing doesn’t work well. We do know one thing for sure: Every day that you don’t invest in bonds, but leave the money in cash, you lose that day’s interest. Thus, for us our strategy is simple: Invest all the cash currently in a custom bond ladder of the highest quality tax-free munis.

If you try to time the market, you are making the statement that you know whether the economy and interest rates are going up or down. We know that we don’t know the direction of either. We do know that if you don’t sell your stock you have not locked in gains. With high quality bonds you can count on the cash flow and return of principal when they come due, however interest rates move.

The fact that interest rates are near historical lows is meaningless. The Fed and its minions have indicated that negative interest rates seem to have worked in Europe. We suspect that it is possible when the next recession comes (and it will come sometime), our Fed may contemplate negative interest rates. If so, our current rates may seem generous.

Interest rates do not move in tandem as a single block. Short-term rates may rise, while longer-term rates may fall. The media never discusses the finer points of bond investing. Investing in individual bonds is considered "dead money" for brokerage firms, and thus the step child of the investment marketing world.

Changes for the Better

While there are many dark clouds in view, the banks and stock market are in much better economic shape than in 2008-2009. The Federal Reserve has announced that inflation is running at less than 2 percent over the last 12-month period. Though some may question the accuracy of this inflation calculation, increases in federal social security benefits and debt restructuring is based upon it. Accordingly, the Fed has initiated balance sheet "normalization." They expect that "economic activity will expand at a moderate pace, and labor market conditions will strengthen somewhat further." The financial world of muni bonds will not come to an end. All institutions and individuals adapt. They have no choice but to go forward and try to improve their position.

Here is what we believe will **NOT** happen:

- The highest quality states will NOT default and repudiate. Legally they can't repudiate.
- The states will not just continue to raise taxes, stop all programs and give all the money to retired and current state union workers.
- The younger generation will not just agree to pay all the rising taxes and other government money to the old generation that has impoverished them.
- The Federal government will not bail out the states, though in difficult times, policies may be enacted to ease a general crisis. If the federal government were to assume the states' self-created burdens, it would be like letting Pandora out of the box.

You can compare municipal finance to the steering of a great ocean liner. It takes a long time to turn, but it eventually does. It could also be compared to whack a mole. Some writers have described an endemic problem like insufficient funding of pensions and other post-employment benefits (OPEB) that workers receive at retirement. They may be ignored until many other authors take up the issue. Eventually, if the issue is not resolved quickly, you read about it everywhere. When a crisis appears irreparable that is when you know that something must change.

Ballooning Public Debt

We feel deeply for the municipal workers who are pawns in the governmental processes. After President John Kennedy allowed public sector employees to strike, the politicians made a deal with the union leaders. The politicians got re-elected by eliminating strikes and the pension reckoning until after they were out of office. The union leaders were able to show their workers the great gains they made – that would be paid in the future.

The future is here now as the baby boomers start to retire. Municipal workers' defined benefit plans provide attractive fixed pensions, including annual cost of living increases which outstrip current inflation. The question is: Where is the money coming from to pay for these benefits?

While everyone agrees that the rich should pay more, the bottom 50% of the population pay only 2.83% of the total federal income tax take. Their share is so low because this calculation does not include Social Security or Medicare taxes. In addition, many people in this category get substantial relief through refundable tax credits.[i] The rich and richer vote with their feet, in response to tax-the-rich policies.

Protections of union pensions and OPEB benefits vary from state to state. Pension benefits may be protected by a state constitution, contract law, property law, or promissory estoppel. These laws may protect past and possibly future benefits, past benefits only or no benefits. In Illinois, New York and Alaska, past and future benefits of their pensions are protected by the state constitution, making them the most difficult to change.[ii]

Reigning in Pension Benefits: Politicians seek alternatives to ballooning municipal pensions, as described below.

- Missouri has launched a limited pension buyout for former state employees who are fully vested, but not yet retired. The alternative to widespread adoption by municipal workers could be that the pension plan runs out of money.
- Arizona adopted a defined contribution plan for new correction officers, and replaced the existing permanent benefit increase with a cost of living adjustment tied to inflation.
- A California Appellate court ruled unanimously in August 2017 that future pension benefits could be modified, in contrast to the 1955 "California Rule" which states that employees have the right to continue earning pension benefits throughout their careers that are at least as good as those offered when they were hired. A challenge to the ruling is pending in the U.S. Supreme Court. The following states

cited the California Rule in their own pension decisions: Alaska, Colorado, Idaho, Kansas, Massachusetts, Nebraska, Nevada, Oklahoma, Oregon, Pennsylvania, Vermont and Washington.[iii]
- Fort Worth Texas: Lower court found that Section 66 prohibits the impairment of accrued benefits for vested employees, but does not prohibit pension reform that would decrease expected but as-yet unearned benefits.[iv]
- In Pennsylvania, Governor Wolf allowed a 2017 education law to be enacted that does not protect tenured teachers from being fired for poor performance.
- Houston, Texas voters approved borrowing to infuse $1 billion into its police and municipal workers pension funds. This step will help chip away at Houston's $8.2 billion pension debt in exchange for $2.85 billion in concessions from workers.

What We Think Now: Preservation of Capital and Cash Flow Creation

We believe that the safest investment for taxable accounts, after Treasuries and Agency bonds, is the highest quality longer-term US tax-exempt muni bonds, where we invest all our personal funds. After you retain cash for your emergency fund, initially you can invest in shorter-term bonds scheduled to mature according to your personal financial timeframe, to provide cash flow and principal for anticipated needs (e.g., home purchase). Long-term bonds become short-term bonds over time.

We are believers in the all-bond portfolio, which has worked well for us and our clients since we discovered bonds in the 1970s, through times of inflation and deflation.

We do not believe in asset allocation since such allocation away from the highest quality bonds increases risk. Our priority is to preserve our principal.

We believe in the overriding value of safe and predictable cash flow as the key to our investing process. However, you know all this about us since you are reading our newsletters.

We hope you enjoy the holidays, eat lots of good food, and that you experience ease and well-being.

Key Words: California Rule, public pension funding, individual municipal bonds, Houston pension settlement, Fort Worth pensions, Philadelphia teacher seniority, creating cash flow

[i] The Kiplinger Tax Letter, October 20, 2017.
[ii] Wells Fargo Advisors Fixed Income Analysis: Municipal Insights. “Local Public Pension Funding.” March 23, 2017.
[iii] Kyle Glazier. ‘California Rule’ Case Could Bring National Pension Ripples.” The Bond Buyer, 12/22/16.
[iv] “Court’s Texas Ruling Seen helping Texas Cities.” The Bond Buyer. 9/28/16.