Texas Muni Bonds & How the PSF Plays a Role in the Market

The Texas municipal bond market provides citizens a promising tax-exempt investment strategy that requires little apprehension and is further supported by bond guarantees of the Texas Permanent School Fund. In this paper, I first introduce the national municipal bond market, emphasizing the benefits and disadvantages of investing in these bonds in our current economic status. I then analyze the Texas municipal bond market in greater detail to determine whether the state’s condition suggests optimism for investment in these bonds. Next, I discuss the impact of the Texas Permanent School Fund and how it’s bond credit enhancement program has affected bonds issued by Texas school districts. I ultimately integrate this information to create an informed decision about the condition of Texas’s municipal bond market altogether.

Municipal bonds provide a conservative investment strategy to preserve capital while generating tax-free income. While municipal bonds are available in both taxable and tax-exempt options, the tax-exempt bonds are typically the investment of choice when investing in this sector. They are a popular investment option for both reducing one’s taxes and providing a lower risk alternative to securities that strictly follow the rise and fall of the volatile stock market. Typically, they are sought out by investors who are able to benefit most from tax exemptions. Municipal bonds are not risk free and many variables contribute to their risk. Yield is usually closely correlated to quality of the issuer and duration of the bond. They often have lower yields than taxable bonds. Long-term municipal bonds tend to incur greater risk, but resultantly gain more exposure to higher returns if interest rates significantly drop before their respective
maturity dates. While there is some level of predictability regarding this risk, many risks involved in municipal bonds are unforeseen. The credit risk of a bond represents the ability of the issuer to provide its investors regular interest and principal payments. The issuer’s credibility can be estimated by a credit rating agency, but the grades the companies assign do not ensure repayment to the investor. Although it’s rare, credible issuers can and do default. Most notably, Detroit, Michigan filed for bankruptcy in July of 2013, resulting in the largest ever municipal default. The president of Merritt Research Services in Chicago, Richard Ciccarone, warns both investors and political leaders after the fall of Detroit that “you can’t treat municipal debt as a risk-free investment” (“Detroit”, 2014). Just recently, Puerto Rico has fallen into more than $72 billion of debt and essentially defaulted on bonds that were constitutionally guaranteed by the government.

Despite their risks, municipal bonds are a valuable investment and statistics prove that they are likely worth it. According to a report summarizing the performance of the national municipal bond market over the past quarter – April 1 through June 30, 2016 – we continue to see positive returns almost entirely across the board. Barclays Municipal Bond Index gained 2.61%, claiming its fourth consecutive positive quarter and thirteenth consecutive positive month. These results outperformed US Treasuries, which resulted in a return of 2.10% over this same period of time. The investment firm, Franklin Templeton, attributes this success to “the flattening of the municipal bond yield curve, strong flows into retail vehicles and low net supply relative to historical averages, as well as a risk-off market environment toward the end of the period” (“Municipal Bond Market Review”, 2016). England’s vote to leave the European Union appears to have caused a slight increase in risk aversion, and overall, the municipal bond market is looking like an optimistic place to invest. The challenge is in determining which bonds result
in the greatest gains. Specifically, does Texas’s municipal bond market prove to be equally as promising as the national market appears to be?

Relying on the dependable lessons of Investopedia, I looked to the article, “How to Find the Best Bets in Muni Bonds” to determine the validity of the Texas municipal bond market. The article, written in June 2015, states the tax-free benefits along with the inevitable risks inherent in all municipal bonds. They start off by providing advice on how to best maximize your experience in the market. Early on, the author states the importance that geography has on the success of a municipal bond claiming that “an AAA-rate municipal bond issued by a thriving city like Austin, Texas, is going to be safer than [a] municipal bond issued by a shrinking city like Charleston, W.Va.” (Moskowitz, 2015). Having a city of Texas posing as the poster child for municipal bond markets surely bodes well for the state. The author then presents a list of the ten safest and ten most dangerous states, counties, or cities in which to invest. Austin is listed as number one on the list of safest options followed by two other areas of Texas later down the list including Williamson County and San Antonio. Of the ten safest areas, Texas holds three of those spots, more than any other state in the U.S. In addition, there are no places in Texas listed on the list of most dangerous investments. The potential for growth in the Texas economy leads to a greater likelihood that issuers will have the capital to pay back its investors. Texas provides great optimism in this regard, there are other features that one must consider. State liabilities, municipal debts, and balance sheets all affect the municipal bond market. The managing director for Municipal Market Analytics in Concord, Massachusetts addresses the stress placed on states due to “higher fixed costs like pensions and retiree health care costs, increased debt costs and more modest revenue increases”. She expresses concern for one issue in particular, saying that she is “more worried about credit deterioration in states with significant pension issues”
(Bernard, 2015). Three states – Illinois, Kentucky, and Connecticut – funded less than half of their pension programs according to an article on CNN Money posted in the summer of 2015. (Lobosco, 2015). Texas funded a respectable 80% of its pension programs in 2013, although this value has been decreasing by small percentages since 2011 (“The State”, 2015). Though if the state’s ability to fund pension programs continues to decrease, it can lead to a weakened financial state indicative of its ability to pay back bonds. While this topic may not demand immediate concern because there is no direct correlation between these two concepts, the topic of oil revenue tells a different story. A handful of states, namely Alaska and Texas, can expect to see decreased returns in the near future due to their reliance on oil, natural gas, and mining.

According to a second quarter report in 2016 on the municipal bond market, a recent study predicts weaker fiscal years in 2016 and 2017 than the returns observed in fiscal 2015, but reporters especially expect a dip in revenue for the states dependent on natural resources (Municipal Bond Market Commentary, 2016). This is an issue that could leave a permanent mark on the previously strong record that Texas had held in the municipal bond market.

The Permanent School Fund (PSF) stands as one of the most successful entities that distinguishes Texas’s financial status in the bond market from that of other states. The PSF was established in 1854 to assist public education in Texas. This fund helped to alleviate the burden of funding public schools from taxes alone. Approximately two decades later, the $2 million of investments provided by the Texas Legislature back in 1854 began to dwindle due to a combination of loan defaults and the Civil War. Resultantly, the Constitution of 1876 granted the fund lands within the state, allowing all proceeds from the sale of those lands to benefit the PSF. In the years that followed, more lands and rights were awarded to the fund. The lands belonging to the PSF now consist of 428,000 acres in West Texas, 84,000 acres in other regions, and most
notably, 12.6 million acres of submerged land in the Gulf of Mexico. These mineral-reserved lands in the Gulf Coast provide a constant stream of revenue from any and all mineral extractions that occur. The royalties on these extractions generate the greatest source of revenue for the PSF (The Texas, 2013). At the end of fiscal 2014, the fund was reported to be the largest educational endowment in the nation. As of August 15, 2015, the PSF’s total balance summed to $33.8 billion. This is $1.1 billion less than the balance reported the previous year, and the Annual Report deems this decrease to be primarily a result of $0.8 billion that was dispersed to a number of public and charter schools in the state (“Texas PSF – Annual”, 2015). For some school districts, the fund supplies more than a fourth of the district’s revenue allotted for public education (The Texas, 2013). In efforts to continue expanding the PSF to provide for these schools, the fund invests in thousands of holdings. The precise portfolio mix categorized by asset class as of August 31, 2015 is shown below.

The largest allocation of funds lies in domestic small and mid cap equities, while the smallest allocation is in the form of cash. An explicit list of all holdings, as well as their book and fair values, can be found on the Texas Education Agency website (“Texas PSF – Holdings”, 2015).
Due to the size of assets available in the fund, it ensures both high liquidity and little risk of default. As a result, the PSF has received AAA credit ratings from the three major credit rating agencies in the U.S. In order to make use of the financial stability presented by the PSF, a state constitutional amendment sought a way to incorporate the fund into public school districts across the state.

In 1983, this amendment authorized the PSF to guarantee bonds issued by public school districts in Texas, leading to the creation of the Bond Guarantee Program. The program is now designed to insure the bonds of both public and charter school districts that would typically have lower credit ratings. With the guarantee of the PSF’s program, these school districts have the capacity to receive AAA ratings from all credit rating agencies. Districts across the state, regardless of their financial standings, are consequently able to borrow at lower costs. Since inception, the program has guaranteed “6,135 school district and 29 charter district bond issues for a total of $137.7 billion and $764.7 million, respectively”. During fiscal 2015 alone, the number of issuers backed by the Bond Guarantee Program increased by 8.3% (238 issues), resulting in an increase of 9.6% ($5.6 billion) in the amount of money affixed to these issues. These bonds are not only well-insured by the PSF but also because most of the issues are secured as unlimited general obligation bonds. In addition, the Bond Guarantee Program is only verified to insure a par value of debt up to two and a half times the book value of the PSF. As a result, the fund is unlikely to find themselves overextended. In any case, the issuers rarely default due to a thorough application process that occurs before receiving a guarantee from the fund. All bonds must be approved by voters in the school district, the district must be state accredited, and if accepted, the issuers have to submit yearly audited financial statements to the PSF (“Texas PSF – Annual”, 2015). With this extensive process in place along with the numerous other precautions,
the Bond Guarantee Program provides Texas school districts with a safe and cost-effective alternative to accessing the finances they need.

In conclusion, the Permanent School Fund proves to be a near-ideal system to bolster the performance of an already thriving municipal bond market in Texas. The PSF will continue to benefit the state as long as they actively manage their investments and keep their leverage ratios at appropriate proportions. In fact, many other states have acknowledged the success of the PSF and the Bond Guarantee Program, and decided to adopt their own school district bond credit enhancement programs as well (State, 2015). The Texas municipal bond market appears strong. That being said, bond markets tend to fluctuate with the economy and interest rates. Studies do predict fiscal 2016 and 2017 to result in less success associated with the municipal bond market than what we’ve seen in the past year. In addition, the revenue stemming from mineral extractions, particularly oil, may leave unprecedented marks on the clean record of Texas municipal bonds. Investors would be wise to enter the Texas municipal bond market with enthusiasm as well as a few reservations.
References


The Top 10 Safest Municipal Bonds. Retrieved August 15, 2016, from