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US MUNICIPAL BONDS
THE CASE FOR MUNICIPAL REVENUE BONDS

DECEMBER 2024

QUICK GUIDE TO US MUNICIPAL BONDS

US municipal bonds, also known as muni bonds or munis, are bonds issued by US states, cities or local government bodies. They can take the form of general obligation (GO) bonds, funded via tax revenues, or revenue bonds, secured by an income stream from a specific local infrastructure asset. Historically, this has meant that default rates have been low, making munis an attractive investment for risk averse investors, and a way to diversify corporate bond holdings.

The majority of municipal bonds are issued in a format that exempts the holder from US federal income tax, and potentially local state taxes – a significant benefit for many US-domiciled citizens and corporates. However, there is a growing section of the municipal bond market that is issued in a fully taxable format – by issuing fully taxable debt, the issuer has greater flexibility on how they can use the proceeds. Taxable municipal bonds generally trade with a higher gross yield than their tax-exempt counterparts, and we believe that this has led to an increase in demand from non-US investors.

EXECUTIVE SUMMARY

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- Revenue bonds fund a wide variety of public projects, many of which are effectively monopolies with captive revenue streams
- General obligation bonds are issued by states and local government bodies, funded by sales, income and property tax revenues

REVENUE BONDS OFFER COMPLEXITY PREMIUM // 4

- Having to understand a specific project is more complex, which means revenue bonds generally offer higher yields – a complexity premium
- For institutional investors able to perform the necessary credit work, this can represent an opportunity

THE DIVERSE RANGE OF ASSETS UNDERLYING REVENUE BONDS ALLOWS CUSTOMISED PORTFOLIOS // 5

- Different types of infrastructure projects carry different types of risk, and are priced accordingly
- This allows portfolio customisation and diversification

ASSESSING MUNI SPECIFIC CREDIT CONSIDERATIONS – REVENUE BONDS WIN OUT // 6

- Although default rates amongst muni issuers has been historically low, there are risk factors that need to be taken into account
- In general, we believe revenue bonds are better positioned to weather these risks

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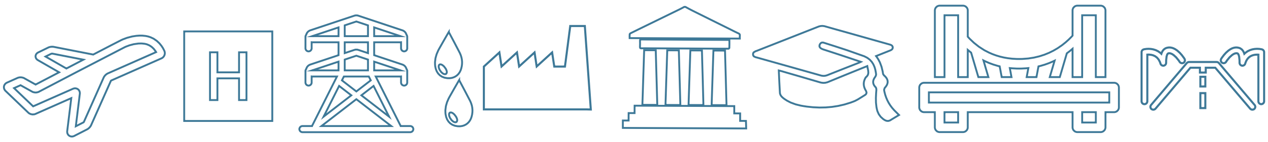
REVENUE VERSUS GENERAL OBLIGATION MUNICIPAL BONDS



REVENUE BONDS – BACKED BY SPECIFIC INFRASTRUCTURE REVENUE

These fund a wide variety of public projects, including toll roads, bridges, water and sewage plants, electric systems, airports, hospitals and public universities, among many others. From a fundamental credit standpoint, many of these public corporations are virtual monopolies that deliver services with inelastic demand to the public. Therefore, revenues are extremely reliable, even during weak economic cycles.

Key characteristics

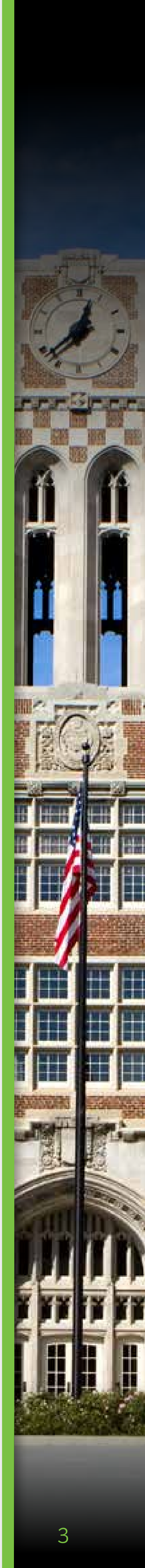
- Interest and principal repayments are financed by dedicated income streams from specific projects, i.e. toll collections from a toll road.
- Generally, longer maturities allow time for sufficient revenues to accrue to repay the principal.
- Detailed credit analysis is required to identify and assess the unique risks and characteristics of the underlying infrastructure assets and how they are being managed.
- Disclosures and financial reporting from bond issuers are often more frequent and transparent than those of many local government GO issuers.
- While revenue bond issuers lack the taxing power of state and local governments, issuers generally have the ability to raise rates and fees to maintain financial performance and meet bond covenants.

GENERAL OBLIGATION BONDS – BACKED BY TAX REVENUES

Backed by the 'full faith and credit' pledge of the issuer, supported by local taxes and fees. State GOs are mainly supported by sales and income taxes, while local GOs are backed heavily by property taxes. These more cyclical revenue streams can cause deficits to widen during recessions, with implications for credit ratings.

Key characteristics

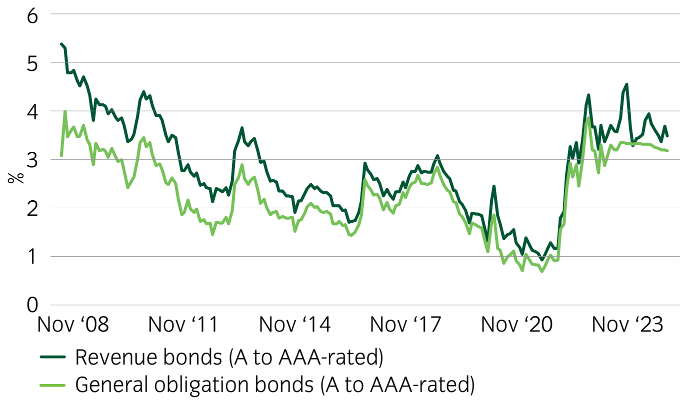
- Interest and principal repayments are financed by the tax revenues of the issuing state, city or local authority.
- Favoured by retail investors as the risks are simpler to understand.
- Tax revenues supporting GO bonds are tied to more economically cyclical sources.
- Because GO bonds are backed by taxes paid by the public, voter approval is often required before issuance; in some cases, statutory debt limits apply.
- Stock market volatility has implications for those issuers heavily dependent on capital gains tax revenues.



REVENUE BONDS OFFER COMPLEXITY PREMIUM

Retail investors are the largest buyer base of municipal bonds, but due to their lack of familiarity and analytical credit expertise their demand for revenue bonds is less robust. We believe thisgenerally results in higher yields than would be justified by the sector's strong credit fundamentals – a complexity premium. For institutional investors, able to perform the necessary credit work and creating a diverse portfolio of issues, complexity premium is a way to enhance yield without additional credit risk.

Figure 1: Revenue versus general obligation yield advantage over time[1]



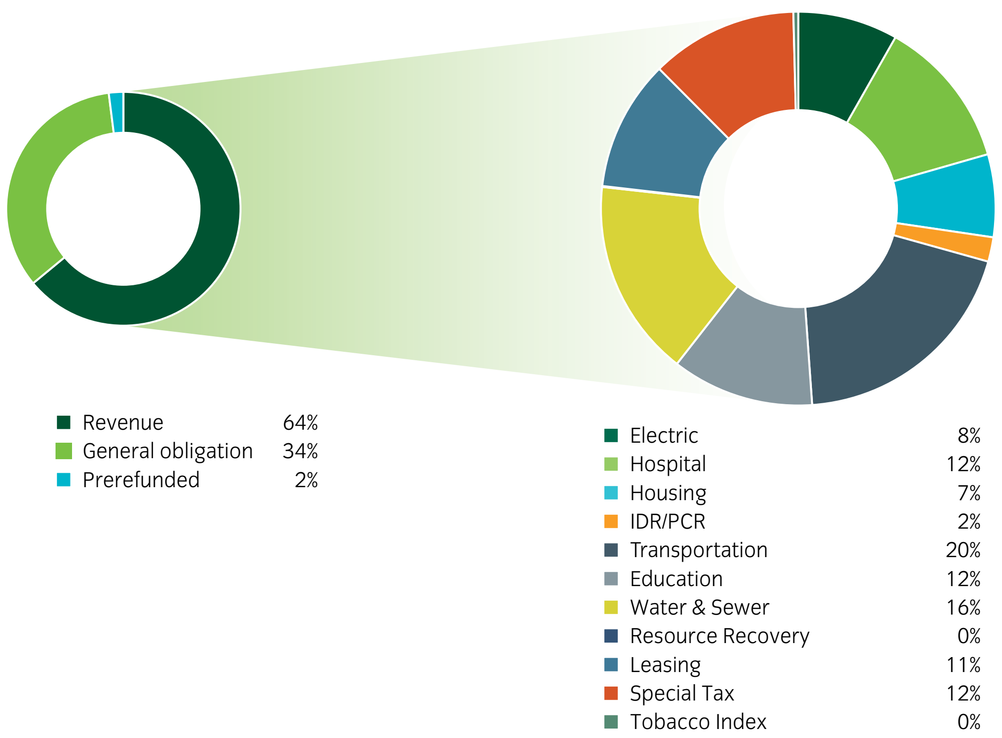
[1] Source: Bloomberg Municipal Bond Index, as at 30 November 2024.

THE DIVERSE RANGE OF ASSETS UNDERLYING REVENUE BONDS ALLOWS CUSTOMISED PORTFOLIOS

A key attribute of revenue bonds is their direct link to revenue streams from underlying infrastructure assets. These infrastructure projects are initially financed with the proceeds from the municipal bond issuance; then interest and principal repayments are met by the revenues created by the infrastructure asset. For example, a hospital could be constructed or upgraded via a municipal bond issue, with the revenues received by the hospital, or its new facilities, used to repay bond holders.

Different types of projects tend to carry different types of risk and are priced accordingly. For example, healthcare and housing projects are generally higher risk than transportation. For investors with the necessary expertise, a portfolio can be customised towards sectors and specific projects that are underpinned by high quality assets and predictable income streams. Asset allocations can be adjusted depending on the economic outlook. With revenue bonds representing a significant proportion of outstanding municipal issuance and a broad range of sub-sectors and projects, there is significant scope for diversification.

Figure 2: Revenue bonds make up two-thirds of the muni market with diverse infrastructure project exposure[2]



[2] Source: Bloomberg Municipal index. As at 30 November 2024.

ASSESSING MUNI SPECIFIC CREDIT CONSIDERATIONS – REVENUE BONDS WIN OUT

In general, municipal bonds are generally high quality, with low default rates relative to the corporate bond market. From 1970 to 2022, investment grade muni bonds, from AAA to BBB, experienced a cumulative default rate of only 0.09% versus 2.23% of IG global corporates within 10 years of issuance. The aggregate muni default rate is around one quarter of the average default rate for US AAA corporates of 0.34%[3].

RISING PENSION BURDENS – GENERALLY FAVOURS REVENUE BONDS

While there has been widespread pension reform among state and local GO issuers, we expect costs associated with pension and other post-employment benefits, such as health care, to continue to frequently outpace revenue growth. Furthermore, rating agencies appear to have increased their emphasis on pension funding, leading to negative rating actions in recent years.

Compared to revenue bond issuers, state and local GO municipalities are more labour intensive, which fuels a greater proportion of revenue share needed to cover pension and health care costs. This gives rise to fiscal challenges, particularly for those issuers lacking the financial flexibility to effectively meet escalating pension liabilities by either increased contributions, raising tax revenues, issuing debt or reducing expenses.

POLITICAL RISK – REVENUE BONDS LESS VULNERABLE

Careful examination of the political environment is necessary to ensure state and local administrations are driving prudent fiscal management. This includes realistic budget forecasts, willingness to take remedial steps to raise taxes and/or implement spending cuts, and pass timely budgets and legislation. The political willingness to pay is increasingly as important as the financial ability to pay.

In most bankruptcy cases to date, the treatment of GO debt led to aggregate recovery of principal generally averaging between 40% and 60%. We believe essential revenue service bonds are better insulated from political risk due to professional management, frequent and independent rate-setting ability and dedicated tax revenue streams and operations that are separate and distinct from the general government.

BENEFICIAL CAPITAL TREATMENT

Under Solvency II regulation, insurers can benefit from investing in infrastructure-related bonds that satisfy certain criteria for classification as a Qualifying Infrastructure Corporate Investment (QICI). Many US municipal revenue-backed bonds meet these requirements. As Figure 3 shows below, under Solvency II, bonds categorised as QICI achieve a capital reduction of around 25% when compared to corporate bonds of similar credit quality.

Figure 3: Lower capital requirements for QICI bonds[4]

	AAA	AA	A	BBB	NR
10-Yr Corporate	7.0%	8.5%	10.5%	20.0%	23.5%
Qualified Infrastructure Corporate Investment	5.3%	6.4%	7.9%	15.0%	15.0%

[3] Source: Moody's Investors Service as at 19 July 2023 Average Corporate Debt Recovery Rates for senior unsecured bonds 1970-2022.
[4] Source: European Insurance and Occupational Pensions Authority, Insight Investment.

SPECIAL REVENUE PROTECTION FAVOURS REVENUE BONDS IN LOCAL GOVERNMENT BANKRUPTCY

In a rare municipal bankruptcy, revenue bonds have historically been insulated from a state or local government insolvency, with the sole rights to dedicated revenue streams. This position was called into question by a 2019 ruling from a Puerto Rico bankruptcy judge who noted the payment of revenue bonds in municipal bankruptcies is voluntary, not mandatory.

We believe the impact of the defended ruling will mostly be limited to a small number of credits with very weak underlying government credit profiles. Credit rating agencies have also taken this view, adjusting their analytical approach to tie ratings closer to the underlying government ratings. Overall though, the ruling in and of itself does not change the secured nature of the revenue debt in question, it merely interrupted the debt service payment during the bankruptcy proceedings, and made the debt service payment subject to the automatic stay provision of the bankruptcy code. It does, however, reinforce the importance of strong fundamental credit analysis.

ECONOMIC RISK – REVENUE BONDS CAN BE LESS ECONOMICALLY SENSITIVE, BUT HAVE SPECIFIC PROJECT RISK

Generally speaking, taxes (such as state, income and sales) are subject to greater cyclicality than the revenue streams from infrastructure assets. However, the pandemic has introduced the risk that whole sectors can be faced with a 'sudden stop' as states are locked down to prevent the spread of a virus. This can have more severe consequences for municipal bonds backed by certain types of infrastructure asset such as airports. As a revenue bond is reliant on the income of a specific project, if that project is not generating its projected income it can lead to the risk that there will be insufficient revenue to repay the principal in full at maturity. Diversification is a key way to address this risk, ensuring that portfolios are not overly concentrated to any particular type of project. It is also critical to pinpoint whether bonds are insured against any revenue shortfalls by their issuing state or are non-recourse.

Figure 4: Summary of municipal-specific credit risks

	General obligation	Revenue
Repayment source	Taxes and fees from underlying state or local governments	Revenues from underlying public projects
Pensions	Rising retiree costs (pension and healthcare) can cause budget stress and crowd out spending	Issuers generally less labour intensive so pension exposure less
Default/ bankruptcy	States can't file bankruptcy and approximately 50% of local governments can't file	Defaults/bankruptcies remain rare and concentrated in non-essential purpose issuers
Economic risk	Cyclical tax revenues sensitive to economic swings	Predictable income and stability in weak economy
Political risk	Political considerations drive fiscal management. This includes failure to pass budgets and legislation, reluctance to raise taxes or reform pension system	Professional management, dedicated revenues and separate operations from local government
Bond covenants	Unlimited taxing power	Special revenue status offers protection in event of local GO bankruptcy

CONCLUSION

We believe a targeted allocation towards municipal bonds is a way for investors to better optimise their portfolios and diversify their credit holdings. Within that allocation, we believe the ability to invest in both GO and revenue bonds provides the greatest opportunity to exploit market inefficiencies as they occur. Both security types, with their differing repayment sources, carry various levels of risk that can be addressed through fundamental credit and quantitative analysis. In general, however, Insight's strategies have a preference for revenue bonds due to their essential service nature, monopolistic service areas, strong credit fundamentals and the historically attractive yields they offer investors.

We focus heavily on high-quality, stable issuers in economically strong service areas with solid credit characteristics and bond income sources that are better insulated from economic slowdowns. Select GO bonds also can play a role in our portfolios if they are fundamentally sound, possess strong liquidity characteristics and the issuer is devoid of pension obligation challenges.

IMPORTANT INFORMATION

RISK DISCLOSURES

Past performance is not indicative of future results. Investment in any strategy involves a risk of loss which may partly be due to exchange rate fluctuations.

The performance results shown, whether net or gross of investment management fees, reflect the reinvestment of dividends and/or income and other earnings. Any gross of fees performance does not include fees, taxes and charges and these can have a material detrimental effect on the performance of an investment. Taxes and costs incurred when purchasing, holding, converting or selling any investment, will impact returns. Costs may increase or decrease as a result of certain currency conversions, such as currency hedging, investment exposure to international markets, and exchange rate fluctuations.

Any target performance aims are not a guarantee, may not be achieved and a capital loss may occur. The scenarios presented are an estimate of future performance based on evidence from the past on how the value of this investment varies over time, and/or prevailing market conditions and are not an exact indicator. They are speculative in nature and are only an estimate. What you will get will vary depending on how the market performs and how long you keep the investment/product. Strategies which have a higher performance aim generally take more risk to achieve this and so have a greater potential for the returns to be significantly different than expected.

Any projections or forecasts contained herein are based upon certain assumptions considered reasonable. Projections are speculative in nature and some or all of the assumptions underlying the projections may not materialize or vary significantly from the actual results. Accordingly, the projections are only an estimate.

Portfolio holdings are subject to change, for information only and are not investment recommendations.

ASSOCIATED INVESTMENT RISKS

Fixed income

Investments in bonds are affected by interest rates and inflation trends which may affect the value of the portfolio.

A credit default swap (CDS) provides a measure of protection against defaults of debt issuers but there is no assurance their use will be effective or will have the desired result.

The issuer of a debt security may not pay income or repay capital to the bondholder when due. The return risk to a portfolio is higher where a portfolio is highly concentrated in such an issuer.

Derivatives may be used to generate returns as well as to reduce costs and/or the overall risk of the portfolio. Using derivatives can involve a higher level of risk. A small movement in the price of an underlying investment may result in a disproportionately large movement in the price of the derivative investment.

Investments in emerging markets can be less liquid and riskier than more developed markets and difficulties in accounting, dealing, settlement and custody may arise.

Where high yield instruments are held, their low credit rating indicates a greater risk of default, which would affect the value of the portfolio.

The investment manager may invest in instruments which can be difficult to sell when markets are stressed.

Leveraged funds: as a result of market conditions, the value of the assets held by a Fund may fall and result in a higher degree of leverage than is deemed appropriate by the Investment Manager. In order to reduce the degree of leverage, the Investment Manager may seek to reduce a Funds' total asset exposure. Investors would need to subscribe for additional Shares in order to maintain the level of sensitivity to market movements. Where such an event is unanticipated, this may result in the investors having less sensitivity to market movements than they might consider appropriate to their individual requirements until they have subscribed for additional Shares

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