Pulling Back the Curtain on Investing Bond Proceeds

Q&A | August 2021

In an effort to better understand PFM Asset Management's strategy and views when it comes to investing bond proceeds, we conducted the following Q&A session with Christopher Harris, CFA, CAIA. Chris is a director in PFM Asset Management's Structured Products Group. He manages bond proceeds projects for a wide variety of accounts for clients throughout the nation. He is also the firm's primary liaison to the structured investment community.

Where do you start when developing an investment strategy for bond proceeds?

Harris: The investment strategy development process for bond proceeds is similar in many ways to the process used for other funds, including short-term reserves and operating cash. In general, when we design an investment strategy, the process involves first understanding the client's objectives, then determining what vehicles the client may invest in (based upon state code and the client's Investment Policy), and lastly, determining what strategy fulfills these objectives within the client's risk tolerances and preferences.

For bond proceeds accounts, there are typically two types of accounts: cash flow driven ones and reserves. The cash flow driven accounts include project funds, debt service funds and capitalized interest funds. Debt service and capitalized interest funds tend to be a bit more straightforward because the cash needs are usually known in advance and not subject to much change. On the other hand, project funds have cash flows that are dependent upon things such as contractors and the weather — neither of which can be predicted with great certainty. Reserves are designed to be accessible if there is a revenue shortfall on the underlying project. For example, if tuition revenues fall below the amounts necessary to pay principal and interest, the reserve can be tapped to prevent a default. For these accounts, preservation of principal is a primary focus, so these strategies tend to be a bit more conservative from a duration perspective and more selective from a credit perspective.

Once the objectives are outlined, the next step is to determine what the universe of eligible investments is. This is determined not only by state code but also by the governing bond documents. Certain clients may also have bond proceeds covered under their broader investment policy. One of the first things we typically do when working on a bond proceeds engagement is to review the permitted investments language to make it as broad as possible. Our view is that it is better to have flexibility so that the advisor and client can determine what is prudent and most appropriate for each type of account. From there, the optimal strategy can be chosen based on conversations with the client regarding things such as the potential for draws to change, a client's interest rate views, how important certainty of earnings is, and the client's comfort level with various security types and risk tolerance (among other things).

What are some of the common strategies used to invest bond proceeds?

Harris: Common strategies include local government investment pools (LGIPs); money market funds; portfolios of fixed-income securities such as Treasuries, federal agencies, commercial paper, and corporate notes; and structured investment agreements such as guaranteed investment contracts and repurchase agreements. Each of these strategies have applications that make sense. Our job as an advisor is to run a thoughtful and comprehensive analysis and facilitate conversations with our clients and think through the unique circumstances of each transaction in order to determine which approach is the most appropriate.

What are some of the applications for different investment strategies? For example, when might it be appropriate to use an LGIP or money market fund for bond proceeds accounts?

Harris: An LGIP or money market fund may be appropriate when a high degree of liquidity is required due to either highly uncertain draws or very short construction periods. They can also be a part of a broader strategy that includes fixed-rate investments as the liquidity buffer for unforeseen changes in cash flow needs. The majority of strategies for bond proceeds accounts that we work on do have some allocation to a liquidity vehicle regardless of the underlying cash needs. If there is some portion of the proceeds that are not immediately needed, we can then have conversations regarding current and future market conditions and how they align with our clients' interest rate views and biases. We can subsequently determine how much of the proceeds should be invested in an LGIP or money market fund and how much might reasonably be invested in a different manner, such as fixed-income investments.

How does a client's interest rate views impact the investment strategy?

Harris: The yield of an LGIP or money market fund will tend to follow interest rates on the short end of the curve with a lag, so it's important to understand if our client has any interest rate biases. If a client believes that interest rates are going to increase, then a higher allocation to an LGIP or money market fund might be appropriate in anticipation of rising yields. On the other hand, if a client believes that interest rates are going to remain stable or potentially decline, then a higher allocation to a fixed-rate investment such as a portfolio of fixed-income securities might be more appropriate. Either way, sensitivity and scenario analyses can be used to quantify the impact of changing interest rates and reinvestment assumptions, which can then be reviewed and discussed with the client to think through the potential range of outcomes.

Are there other times when fixed-income securities might be appropriate?

Harris: One of the benefits of fixed-income securities is that the yield at which the security is purchased is the return that an investor will realize if the security is held to maturity. In an environment where the yield curve is upward sloping and intermediate yields are higher than overnight rates, there tends to an initial outright yield advantage from the purchase of a portfolio of fixed-income securities relative to an LGIP or money market fund.

If cash flows can be identified outside of the money market fund space — meaning six to nine months and beyond — then an asset-liability matching approach where individual securities are chosen to fund defined liabilities may produce a higher initial yield than an LGIP or a money market fund. Ultimately, the performance of these investment alternatives will depend on future market conditions because the LGIP or money market fund yield will likely change over time as market conditions vary. Any changes to liquidity needs will also be a driver of performance for these accounts. More excess liquidity in a rising interest rate environment may mean that cash is reinvested at higher yields, which could increase the portfolio return, while excess liquidity in a falling interest rate environment tends to be a drag on performance. Alternatively, if an issuer chooses an active management strategy, the portfolio manager may utilize different techniques based on feedback from the client regarding expected cash flow needs, which could also be positive for portfolio performance.

What is the difference between active management and passive strategies?

Harris: Passive strategies are ones where we assist clients with the initial investment or structuring, but then do not monitor or trade on the account afterward. For example, a one-time structuring of a portfolio may be more cost-effective for accounts that have well-defined liquidity needs, such as a refunding or defeasance escrow, because the advisor's ability to add incremental value in excess of fees may be limited.

LGIPs or money market funds are also passive strategies because the client or advisor does not trade on the account, and this is instead done by the manager of the LGIP or money market fund itself. Structured investments are also a type of passive strategy, but the applications may be more limited. These strategies have unique credit, tax, and rebate implications that need to be reviewed with tax and legal counsel in addition to the investment advisor.

Active strategies are ones where the manager constantly monitors the portfolio from both a portfolio composition perspective and a liquidity perspective. Typically, management fees are charged because the advisor is trading on the account more frequently, monitoring holdings, providing additional accounting records and statements, and conducting research. The idea is that the advisor is able to add incremental value in excess of the active management fee.

When might active management for bond proceeds make sense?

Harris: In general, active management is beneficial if the permitted investments are expansive and/or the liquidity needs of the account are likely to change. Active management allows the portfolio manager to add value over time by swapping between sectors—for example, buying federal agencies when spreads widen relative to Treasuries — and by managing changes to the draw schedule. If draws are expected to lag their projections, an active management strategy can prevent too much cash from being reinvested at potentially lower money market fund yields and can instead be redeployed further out the curve in higher-yielding fixed-income securities. Active management may also allow the use of credit instruments because the portfolio manager will be tasked with monitoring the creditworthiness of the underlying issuers held in the portfolio.

Do you believe it is appropriate to use credit instruments in bond proceeds portfolios?

Harris: It can be, but ultimately decisions are based on the client's risk tolerance as well as broader conditions in credit markets. When we use credit instruments in actively managed bond proceeds portfolios, we do so in a way that limits exposure to any one issuer to manage concentration risk. This might mean that for any given issuer, we limit the exposure to 1-3% of the portfolio. This also means that the approved list of issuers needs to be broad and robust enough so that there are enough issuers to allow a meaningful portion of the portfolio to be invested in credit instruments. There also needs to be enough supply to actually go out and purchase these investments, meaning issuers on the approved list need to either have enough supply trading in secondary markets or be active participants in the primary markets. For these reasons, we often find that it takes some time – days, weeks even – to piece together the supply necessary to fully fund the credit piece.

Once the portfolio is structured, monitoring the creditworthiness of the underlying issuers becomes a main focus. Our credit team conducts periodic reviews of all issuers, discusses developments in credit markets, attends earnings calls, reads research reports, and is generally very involved in analyzing not only the current creditworthiness of issuers, but also understanding what developments in the economy and markets could lead to a change in the creditworthiness of issuers (both positive and negative). We typically only use credit instruments in portfolios that we are actively managing because of this monitoring component.

On the other hand, there are some situations where a structured investment for the entirety of the fund may make sense. For example, if it's possible to lock in positive arbitrage, then it might make sense to use a structured investment. Or, if a fund has unique liquidity

or cash flow considerations that cannot be met by a traditional portfolio, then a structured investment might be an appropriate solution. A good example is for a debt service fund that has forward-starting deposits. It's not possible to lock in a rate of return for a deposit that occurs in the future without using a derivative of some sort. A structured investment might help clients that seek budgetary certainty by allowing them to lock in a yield on all deposits for a predetermined period of time.

However, at that point, it becomes a question of risk-versus-return: is the incremental credit risk you are taking commensurate with the additional return that is received? It is important that this is viewed within the lens of the permitted investments. If a fund has a very narrow, limited subset of permitted investments, such as government obligations only, then a structured investment might make sense from a yield perspective. If credit instruments such as commercial paper and corporate notes can be used, then what we often find is that a well-diversified portfolio of credit produces a return that tends to be substantially similar to that of an undiversified, highly concentrated structured investment. We frequently have these conversations with clients and find that the majority of the time, the structured investment may not be the right way to go.

What are some of the other types of risks to be aware of when it comes to bond proceeds investments, and how do you go about managing them?

Harris: The other two main types of risks that we typically consider are liquidity risk and reinvestment risk. Liquidity risk refers to how quickly and easily the investments can be turned into cash, and reinvestment risk refers to how the portfolio's return may change as interest rates change.

Some of the things we think about when managing liquidity risk include if there are redemption fees, gates, or notification requirements. This is most important for money market funds and structured investments, and we typically ask questions related to same-day liquidity and notice periods. For portfolios of fixed-income securities, it becomes more a question of the existence and depth of the secondary market, which can be accessed in the event proceeds need to be received early. For example, it is typically much easier to sell Treasury notes than corporate notes because the Treasury market is much more liquid. To manage through this, we typically make sure we have a large base of Treasuries that can be liquidated instead of corporates. Additionally, frequent communication with the client helps us react and make changes to the portfolio composition in real-time.

Reinvestment risk is ultimately driven by the underlying investment strategy and cash flow changes. For example, a money market fund has the most reinvestment risk because the rate will change over time. A structured investment has the least reinvestment risk if it is held to maturity because the rate of return on the contract is fixed. A portfolio of fixed-income securities tends to be in between the two. The portfolio can be structured to have a majority of investments in fixed-rate fixed-income securities, which eliminates reinvestment risk. However, as draw schedules and/or liquidity needs change, reinvestments or liquidations will occur at whatever the then-current market rates are. This introduces reinvestment risk because the total return on the portfolio will change with market conditions. Either way, we typically have lengthy conversations with clients to determine their interest rate biases (if any), and we look to execute an investment strategy that takes these views into consideration.

What is the typical timeline for bond proceeds investment strategies? When should issuers start thinking about how to reinvest the proceeds of bond issuances?

Harris: We typically recommend thinking about reinvestment early on in the process as documents are being drafted. Having an advisor review the official statement and/or trust indenture language to make sure permitted investments are as broad as possible is an important first step. From there, the advisor can help the financing team with earnings assumptions on funds, which is important from a sizing perspective. Additionally, depending on the strategy chosen, it may take several weeks of onboarding and legal document

review and drafting before the advisor can execute on the chosen strategy. Therefore, starting early will help ensure that the strategy can be executed on or shortly after the settlement date of the bond issue.

What are some of the biggest pitfalls to avoid when investing bond proceeds?

Harris: It is not uncommon for issuers to wait until after the settlement date of the transaction to think about the investment of bond proceeds. Problems can arise due to procurement rules, onboarding, and other administrative details that can result in proceeds being uninvested for some time after the settlement date. We advocate for thinking about investments in tandem with the pricing of the bonds – your advisor should be able to focus the conversation, so it does not become a detractor from your ability to dedicate time to the bond issue itself. Additionally, by focusing on the investments in tandem with pricing, the permitted investments language in the bond documents can be refined to reflect current industry best practices.

Another costly pitfall is having too much liquidity, especially in a near-zero interest rate environment with an upward-sloping yield curve. Most LGIPs and money market funds are yielding at or near 0%, and portfolios of fixed-income securities can generate meaningful incremental earnings depending on the investment horizon. This also illustrates the importance of good communication with architects, engineers, and contractors for expenditure estimates so that liquidity needs can be defined as precisely as possible.

If it is not possible to have a well-defined estimate of liquidity needs, then identifying buckets of money that are not expected to be used for a certain period of time (defined in years, for example) can help with the strategy development.

One of the other major pitfalls is not changing the strategy through time as market conditions change and/or more information becomes available regarding cash flow needs. This is particularly important because changes to cash flow needs tend to be uncontrollable: it is not possible to prepare for construction delays, supply shortages, and dramatic changes in market conditions. Active management of portfolios allows you to react to all of these things and ensure the portfolio is properly structured and diversified to reflect liquidity needs and risk tolerance. Having an open dialogue with your advisor, including frequent and proactive communication, can be beneficial in this regard.

For more information, please reach out to your PFM relationship manager or Christopher Harris, CFA, CAIA at harrisc@pfm.com.

To learn more or discuss in greater detail, please contact us:

Christopher Harris, CFA, CAIA | Director
harrisc@pfm.com | 717.213.3810

The views expressed constitute the perspective of PFM Asset Management LLC at the time of distribution and are subject to change. The content is based on sources generally believed to be reliable and available to the public, however, PFM cannot guarantee its accuracy, completeness or suitability. This material is for general information purposes only and is not intended to provide specific advice or a specific recommendation. PFM is the marketing name for a group of affiliated companies providing a range of services. All services are provided through separate agreements with each company. Investment advisory services are provided by PFM Asset Management LLC, which is registered with the SEC under the Investment Advisers Act of 1940. For more information regarding PFM's services or entities, please visit www.pfm.com.