CHANDLER ASSET MANAGEMENT

The Bond Buyer Pre-Conference

Rewriting the Rule Book:
Effects of Regulation on A/L Management and the Investment of Bond Proceeds

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Interest Rate Swaps: Clearly Riskier than Anticipated

- **Swaps exploited the differential between long and short rates to create arbitrage earnings**
  - But, on the balance sheet, the liability of the bond issue is compounded by the liability of the swap
  - The bond-issuer is exposed to interest rate risk on the swap
  - As well as counterparty risk
- **Although the perfect storm arose during the financial crisis, even more “normal” market conditions could have resulted in losses to the issuer**

Investing Bond Proceeds Using GICs: Also Riskier Than Expected

- **Investment Agreements—Guaranteed Investment Contracts, or "GICs" offered attractive yield and stable market value**
- **Most issuers considered exposure to investment risks in GICs to be minimal**
  - Market risk exposure was masked by the "stable value" aspect of GICs
  - Credit and counterparty risk exposure masked by reliance on NRSRO ratings
- **GICs—like every other investment—were only guaranteed by the provider**
  - Some were collateralized
  - Or had collateralization provisions

Investing Bond Proceeds: Safety First, Last and Always

- **Investment Agreements**
  - Probably gone forever
- **Trustee products—usually money market funds**
  - Diversified portfolios of high quality, very short term securities
- **Pooled vehicles**
  - Government Pools
  - “Private” Pools
- **Portfolios of individual securities**

Investing Bond Proceeds: Safety First, Last and Always

- **Investment Agreements**
  - Provider downgrades and failure to provide required collateral marked the demise of GICs
- **Pooled vehicles, if permitted by indenture**
  - Can be limited to stable value pools, *i.e.*, a diversified portfolio of money market fund-like securities
  - Fluctuating value pools may offer better yield, but can experience market value changes over time
  - Due to investment strategies not as restrictive as SEC-regulated money market funds, they may offer slightly better yields
  - Flexibility and ease: funds can remain in the pool until needed
  - Rate paid will change with market conditions
  - Some had issues during the financial crisis

Investing Bond Proceeds: Safety First, Last and Always

- **Trustee money market funds**
  - Stable $1.00 value
  - Yield (≈0.0% now)
- **Portfolios of individual securities**
  - Transparency—investor controls and sees the specific securities held in the portfolio
  - Laddering with reinvestment provides flexibility
  - Market yields—similar to Pools
  - Must be marked to market

Safely Investing Bond Reserve Funds: What are the Options?

- **Money Market Funds**
- **Pools**
- **Individually managed portfolios**
  - 0-5 year governments: yield approximately 1.00% to 1.15%
  - Mark to market on longer term portfolios could result in required additional contributions to the reserve in rising interest rate environments

Going Forward: Simplicity and Safety

- **Debt Issuance**
  - Straightforward fixed-rate debt is often the simplest option for long term issues, with the lowest cost of issuance
  - Variable rate debt is complicated by a number of risks
    - Added requirements include credit facilities, remarketing agents, counterparty risk, rollover risk…
    - Balance sheet risk mitigation can be illusory
- **Investment of Bond Proceeds**
  - Government securities
  - Transparency
  - Yield is less important than safety

“I’d rather be looking at it than looking for it”

*Unattributed