

Community Finance Brief

Interest-Aligned Community Investments Via Muni Bonds



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“Don’t Say Gay” was the theme of a particularly divisive battle over education policy in Florida in 2022 that drew worldwide attention to the anti-woke agenda. Sexual education, pronouns, book bans and enforcement against teachers in the aftermath of the passing of the Parental Rights in Education bill leave most people in this country with strong feelings one way or another.

This is one of the many areas where public policy in the United States has not impacted community finance in any meaningful way. Most Americans have an opinion on the this particular legislation (those with no opinion on the Florida bill sit in the 9%-12% range) meantime, for a variety of market structure reasons, 72% of all national municipal bond mutual funds have exposure to the Florida Board of Education capital outlay bonds. Following this logic, nearly three-fourths of this nations investors in community finance through mutual funds support the growth of the Sunshine State’s education policy of book bans.

The history in this country of connecting personal beliefs to investments stretches centuries. Quakers in the 18th century were among the first to avoid investing in businesses involved in the slave trade. So called ‘sin stocks’ that held equity in companies with business in alcohol and tobacco were avoided by some in the aftermath of prohibition. The civil rights movement in the 1960s and environmental concerns in the 1970s and 1980s promoted sustainability and responsible resource management. Boycotting Chick-Fil-A or Dominoes because of ownership’s religions views. Aligning personal interests with ones finances is an American right of passage regardless of their utility.

Intrinsic to many social and environmental concerns are our local, state and federal governments. How a community finances schools, hospitals, first responders, jails and the way in which policy is implemented in public entities are incredibly

Quick Takes

The lack of a state income tax in Florida coupled with high investment-grade ratings by all three major rating agencies and its frequency in the municipal market make it a high-grade benchmark and highly held name across the community finance investor universe

Historically, municipal bonds fund most state’s public education systems and are thus a financing arm of each states education policy, which has not changed since divisive ideas such as critical race theory have entered the policy and policy arenas around the country

Impact Investing is soaring in popularity around the global ad in the United States but has yet to carve out real ways in which it affects social aspects of public policy

influential in the way our communities operate. Our federalist system cedes significant control to regional and local governments compared to most other modern democracies.

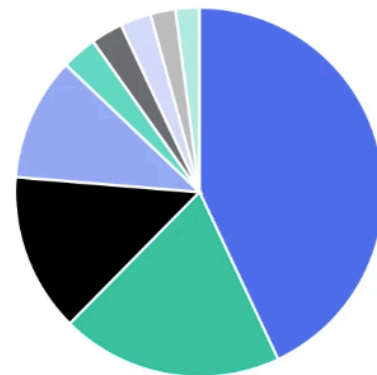
Outside of federal programs, property and income taxes - much of the capital that finances community programs comes from municipal bonds. Bond ballots allow the public to weigh in on the direction of our community governance but in most cases, most American's do not align their personal beliefs with that of their municipal bond portfolio. Considering that municipal bonds supporting "Don't Say Gay" school systems sit in most American's portfolios, the thesis of a disconnect between muni bonds and how they shape a community holds water.

IN COMMUNITY FINANCE A 'HOUSEHOLD' IS NOT WHAT IT SEEMS

The landscape of financial markets in modern history is predicated on scale, which correlates to profit. When it comes to securities, because they are over-the-counter, the financial industry has taken many steps to essentially commoditize the process for the sake of efficiency. While this does allow for

management costs to decline for the individual investor (exchange-traded funds are the extreme of this), it also happens to separate the investor from the entity it is investing in. In community finance, the investor rarely engages directly with the government it is investing in via the bonds issued.

Muni ownership 2Q23



Source: Federal Reserve

Long has the data on investor-type in municipal bonds (provided quarterly by the Federal Reserve) had 'households' as by far the largest segment (see figure, **above**) holding between 41% to 44% for last two decades. This would imply that individuals are picking muni bonds like they do with a stock on E-trade, for example. This is not the case. That is because the denomination of a muni bond is usually \$5,000 (minimum threshold to invest) and a round lot (insinuates an institutional bid at a fair price) is \$1 million. Given that this is the case, it is safe to assume most people are not engaging with this market with regularity.

Instead, individuals hire investment advisors to manage any muni investments of size. Typically they are through a pooled investment vehicle called a seperately-managed account (SMA) and this makes up for the bulk of the 'household' investor segment. SMAs are essentially higher-end mutual funds that cater to high-net worth individuals/families that cater to specific tax strategies or otherwise and have higher management fees. Individual securities

are filed for tax purposes, not a fund vehicle and as such they fall under the 'household' segment per the Fed data.

Looking at the pie chart on the **previous page** of investor-types of municipal bonds, the bulk fall into 'households' and 'mutual funds.' As just discussed with SMAs, this means that the majority of Americans have exposure to community finance with an intermediary making decisions for them. These registered investment advisors and/or portfolio managers have historically been trained to approach the asset class as a low-default, fixed-income tax strategy - not as a way to demonstrate an opinion on how said investment aligns with their personal beliefs.

Backing into the Fed numbers, that means about \$2.4 trillion (mutual funds, households and ETFs) of the roughly \$4 trillion in outstanding community bonds are held by individuals and not corporations. Individuals that could, if they so desired, align their interests with their municipal portfolios, and in many cases earn tax-exempt income and keep a low default exposure.

FUNDS OFFER AN EASY ALBIET LESS IMPACTFUL SOLUTION

A growing movement of connecting social and environmental issues to that of programs funded by municipal bonds has grown over the last decade but the vast majority of people have exposure to the sector know little about how their dollars are being put to work. If properly discussed, this could change and better align communities with what their residents want: a responsive democracy.

The impact movement over the last 10-years in municipal bonds has seen consistent growth and makes up about one-third of all U.S. green bonds issued as of the first half of 2023. This indicates that state and local governments are attempting to tap into the impact market by providing better information about how use of proceeds affect areas of social or environmental concern. The recent SEC ruling on disclosure should help move this along over the next few years as well.

In review, three principals to this approach:

- **Negative screens:** Exclude bonds from issuers with practices that contradict the client's values (e.g., companies with poor environmental records or discriminatory practices).

"...the Earth is the Lord's and everything in it, the world, and all who live in it"
- Psalm 24:1

"Everything is God's, including our money. It falls under the category of 'everything' and it all belongs to Him. I believe the first step in saturating our money management with out faith is to release that ownership back to Him at an emotional and spiritual level, which is probably a moment by moment decision for most of us. "

-Christian Family

Financial: Making

Money Meaningful

- **Positive screens:** Focus on specific sectors or projects aligned with the client's interests (e.g., renewable energy, affordable housing, sustainable infrastructure).
- **Impact investing:** Prioritize bonds directly financing projects with positive social or environmental impact (e.g., community development, clean water initiatives).

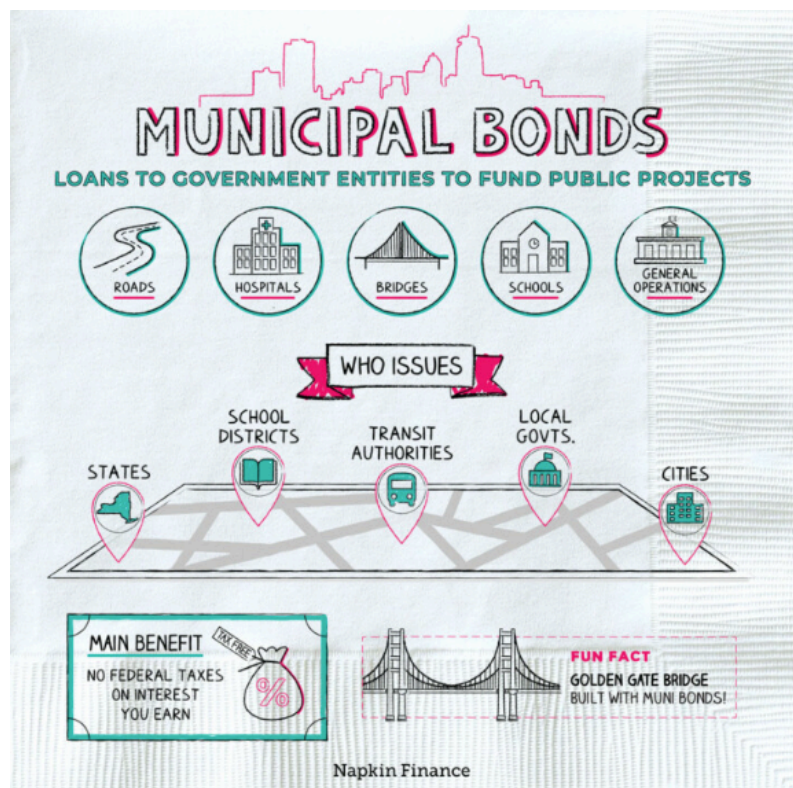
Impact screens are the lowest hanging fruit for the common investor when it comes to aligning interest with a muni portfolio but they don't really offer much else beyond positive/false assessment of an issue (IE - this is ESG, this is not ESG). This is not a slight towards any particular fund complex as they all generally are offer variations of the same. Pooling designated 'green' or 'social' likely moves the needle if these are issues you care about, but it is by no means specific to a community.

JIM LEBENTHAL WAS ON TO SOMETHING

The industry paying more attention to green and sustainable is a net positive but when one considers how impactful \$2 trillion-plus of fixed-income focused investible assets for the country could be, it offers a larger perspective. The ability to humanize how projects funded by municipal securities has largely been lost in the municipal market as process described above has moved the individual investors away from the bond itself.

In New York in the 1970s, the voice of Jim Lebenthal was one that most would recognize if they were listening to the radio and later on local television. Lebenthal was a muni salesman with a knack for showmanship who's adverts became very well known as connecting the subway, the bridges and schools of New York to the muni bonds he was selling. At the time, it was a novel approach of connecting modern marketing and technology to the industry. It even played a role in the late 1970s in helping the city bounce back from bankruptcy.

The growth of the impact market in municipals has thus far generally taken the path of how modern financial markets evolve - where efficiency and profit take precedent over efficacy. As such, we have meaningful labels and categorizations that end up being a marketing tool for the large investment firms to put a new shade of lipstick on the same mutual fund purchased by the previous generation.



IDENTIFY WITH MUNICIPAL BONDS

While not advocating for any position on either side of the issues mentioned above, they all are connected to the municipal bond market. We led with Florida. For active market participants, the Florida State Board of Education is a well known credit as it historical sells multiple times throughout the year and is largely seen as a bellwether credit - a proxy for the high-grade market as a whole. Given that the state has no personal income tax, it prices slightly cheaper to high-tax states and for this reason, Florida school bonds end up in many national, high-grade mutual funds. These are the most popular and largest mutual funds for investors.

This is not intended to be a critique of the policy, but rather a critique of the market for not making this connection. Industry participants complain that the opaqueness and staid nature of community finance keeps it on the back burners. Here is an issue that most people have an opinion on - why not voice it? There are religious-focused mutual funds such as Thrivent Financial for Lutherans that one could assume would see support of Don't Say Gay would be a marketing tool for potential investors.

And this extends into a myriad of other areas. Climate change is impossible to miss when it comes to community finance but there are other areas of interest such as muni bonds that fund private prisons, muni bonds that finance facilities performing in vitro fertilization and offering reproductive rights. Virtually every public University system in the nation and many private ones offer municipal bonds to build new dormitories and expand services on their campus. We hear a lot of charitable donations but little on the University's bond issuances.

An effort to humanize and make municipal bonds more palatable to more people would be to include them in the public discourse of community action and finance.

