

Are Federal Grants Taken for Granted?

President Trump's first budget blueprint proposes to cut the Housing and Urban Development (HUD) department's public housing capital fund by a significant 70%.¹ A reduction of this magnitude would place substantial pressure on the repayment prospects of municipal debt that is backed by HUD capital grants. While the president's plan may not ultimately pass, it illustrates the risks inherent when investing in securitized federal cash flows. We believe these risks are evident in the following ways:

- Such financings leave an investor without the typical proximity to the cash flow source and the lender has little, if any, control over revenue apportionment.
- Federal securitizations lack the relatively more favorable remedies in the event of cash flow shortfalls offered by similarly rated, state, and local tax-backed securitizations.
- Rating agency sentiment changes can subject such securities to potentially outsized rating level risk, which can adversely impact market value.

Municipal issuers have chosen to securitize a number of federal funding sources, most prominently HUD grants and Highway Trust Fund (HTF) receipts. While HUD grant pledges have been constructed in a relatively similar manner, HTF revenue pledges have seen more variety. Certain issuers have solely pledged federal HTF grants in their securitizations – such instruments are referred to as standalone Grant Anticipation Revenue Vehicles (GARVEES) – while others have additionally pledged non-federally sourced tax revenues to augment credit quality. The aforementioned risks in connection with federal appropriations are more directly linked to the standalone GARVEE variety.

Federal securitizations generally carry mid to high investment-grade ratings, but those ratings may betray some of the nascent, idiosyncratic risk factors. Accordingly, a recent history of downward rating migration suggests the growing realization of the specific credit risks that must be accepted in owning these securitizations.

Table 1: Sample Ratings History

	Moody's		S&P	
	At Issue	Current	At Issue	Current
HUD Capital Fund Programs				
District of Columbia Housing Finance Agency, Series 2005	Aa3	Baa2	AA	A
Philadelphia Redevelopment Authority, Series 2002A	Aa3	A2	AA	AA-
Puerto Rico Housing Finance Authority, Series 2003	Aa3	A2	AA	AA-
Standalone GARVEE Programs				
Georgia State Road and Tollway Authority, Series 2009A	Aa3	A2	AA-	AA-
State of North Carolina, Series 2009	Aa3	A2	AA	AA
State of Washington, Series 2012F	Aa2	A2	AA	AA

For illustrative purposes only.

Source: Moody's, Standard and Poor's

Our investment process instructs us to appreciate asymmetric risks such as those inherent in federal securitizations. Applying a proper relative value analysis requires that we understand the relative positioning of these securities in regard to the ability to pay and potential severity of investment loss — both factors in these cases are susceptible to incremental downside risk in our analysis. Therefore, we would require greater compensation relative to the entirety of our investment opportunity set to comfortably accept these aforementioned risks.

¹ http://www.housingfinance.com/policy-legislation/pha-leaders-fear-drastic-budget-cuts_o

Past performance is no guarantee of future results.

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