Investment Insights

Investing in the State of California

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Highlights

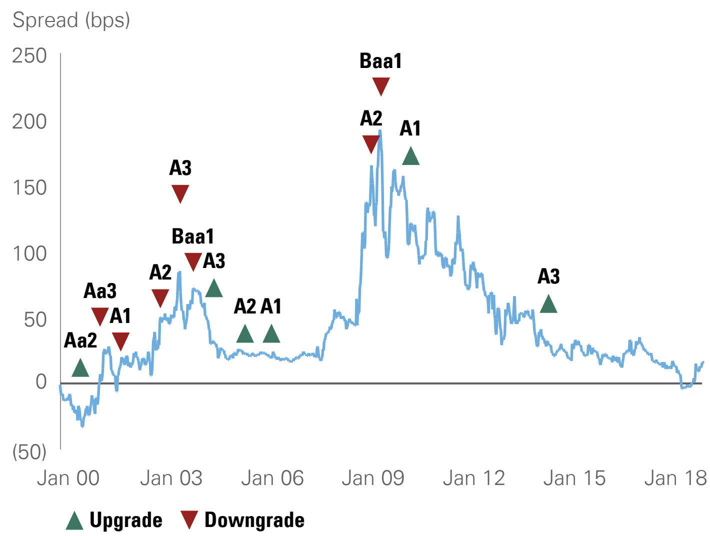
- Fiscal prudence, governance reform, and retirement of internal debt have bolstered California's financial resilience.
- Looking ahead, careful monitoring is required — including the state's financial management practices, the impact of recent/prospective federal policy initiatives, the pulse of the electorate, and the effect of climate change.
- Bessemer seeks attractively valued California bonds in sectors that exhibit less correlation with the state/its credit quality.

California's credit profile has strengthened considerably, but, in order to gain perspective, it is important for investors to recall the state's struggles earlier in the century:

- On October 7, 2003, voters recalled Governor Gray Davis based on perceived mismanagement of the electricity crisis.
- The state's credit rating hit the triple-B category twice in the 2003–2010 period.
- A combined deficit of $41 billion was identified for fiscal years 2009 and 2010.
- The ensuing cash crisis forced the state to issue IOUs to certain creditors — with the possibility of a federal backstop for cash flow issuances bandied about.
- Unemployment hit 25% in a San Diego-area city.
- Between 2001 and 2009, State of California bonds lost over 10% of their value relative to the general universe of municipal securities (Exhibit 1).

Exhibit 1: California Municipal Bond Spreads and Credit Rating History

Key Takeaway: California municipal bonds experienced multiple downgrades from 2001 to 2009, which drove price declines.



As of February 2019. Spreads represent California general obligation bond yields compared to AAA-rated 10-year municipal securities' yields. Bps stands for basis points.

Source: Citigroup

This disheartening picture is not at all what comes to mind when thinking about the "revived" double-A rated California today. As announced by the U.S. Department of Commerce in 2018, California stands as the world's fifth largest economy, has the largest gross state product in the U.S., and accounts for over 14% of U.S. gross domestic product (GDP). Further, California's economy has exhibited above-average strength — with nominal GDP recording a five-year compound annual growth rate (through calendar 2017) of 5.2%, exceeding the nation's 3.7% and trailing only Washington (5.4%) and Utah (5.3%). Above-average growth continued in 2018 as well; as reported by the U.S. Bureau of Economic Analysis, real GDP increased 3.5% versus 2.9% for the nation.

These strong economic tailwinds, combined with fiscal prudence on the part of former Governor Jerry Brown, bolstered California's financial operations and resilience. Significant governance reforms include majority legislative approval for budget passage and the establishment of a budget stabilization account (BSA) — along with a constitutional funding methodology (capital gains taxes above 8% of general fund revenues are allocated to the BSA and debt repayment, rather than increasing spending). In addition, voter-approved temporary sales and income tax increases were applied to pay down California's infamous "wall of debt" ($35 billion at its peak).

This strategy yielded dividends. Reserves have strengthened considerably since fiscal 2009 (Exhibit 2), and the adopted fiscal 2019 budget includes a $2.7 billion contribution to the BSA, with the balance projected to reach $13.5 billion, close to the 10% cap at 9.6% of revenues.

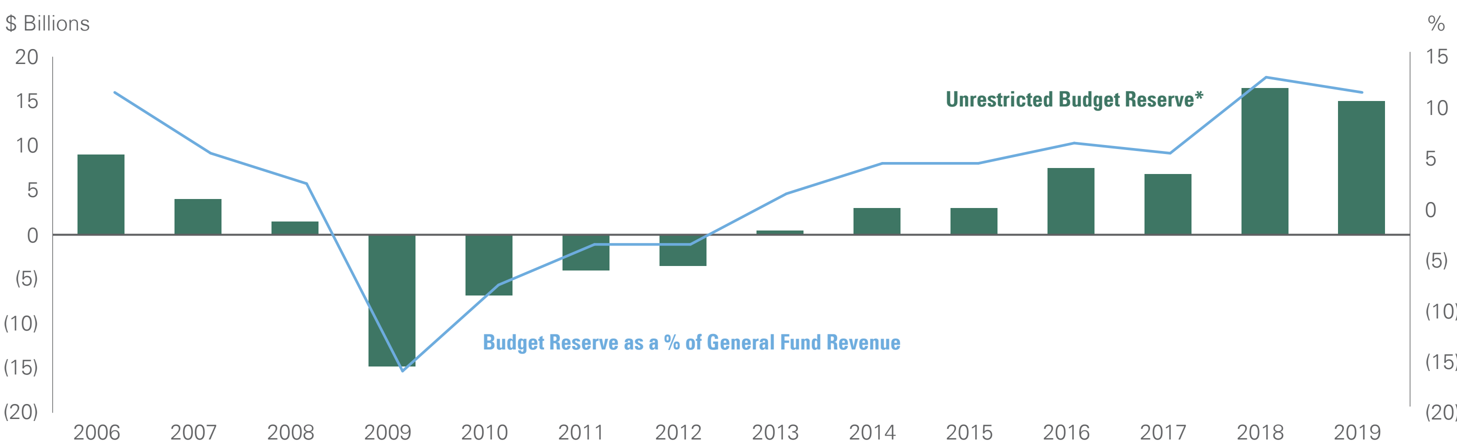
Will the Upward Trajectory Continue?

Given campaign rhetoric, many observers wondered whether Governor Gavin Newsom would continue the path of fiscal prudence. Naysayers were pleasantly surprised. As originally proposed in January, the $144.2 billion general fund budget/$209.1 billion total budget increased spending by 4%, and per the governor, 80% of the increases in the total budget are one-time costs.

While the budget proposal takes steps toward expanding Medi-Cal coverage to young adults (regardless of immigration status), increases funding for education (e.g., includes funding for two free years of community college), and addresses housing production and homelessness via a variety of grants and incentives — it also includes depositing the constitutionally required amount to the BSA (which would increase to $15.3 billion), allocating

Exhibit 2: California Budget Reserves

Key Takeaway: Budget reserves have increased amid economic strength, voter approval of temporary tax increases, and improvement in California's governance practices.



* The budget reserve is the combined Budget Stabilization Account and Special Fund for Economic Uncertainties balances.

Source: State of California/Moody's

about $4 billion to paying down the "wall of debt," and making additional payments to the state's pension plans (expected to save the state about $14.6 billion over the next 30 years). The governor's May budget revision increases spending by about 2% (versus his original proposal), but also includes an additional $1.2 billion deposit to the BSA, increasing the reserve to $16.5 billion; the final fiscal 2020 budget will be enacted in the summer.

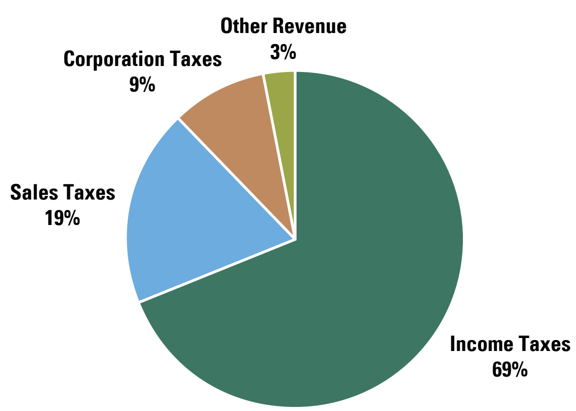
Still, recalling the credit volatility prevalent throughout the 2000s, there is no room for complacency among investors in California bonds.

The state's revenue structure remains dependent on personal income taxes (Exhibit 3) — and the top 1% of earners typically pay over 45% of annual income tax receipts. California currently reaps the benefits of the 2012 income tax increase (expires in 2030; entailed a higher rate on income over $1 million) — however, exposure to negative variance is heightened. In fiscal 2019, for example, an estimated $15.2 billion (11% of total general fund revenue) will come from the capital gains tax. In contrast, in fiscal 2009, capital gains tax receipts fell to a low of 3.4% of total general fund revenue.

Further, the state's budget is rigid in terms of expenditures (e.g., Proposition 98 requires about 40% of general fund revenue be spent on K-14 education), and two-thirds legislative approval is required for tax/fee increases.

Exhibit 3: Sources of Fiscal 2019 General Fund Revenue

Key Takeaway: California is heavily dependent on personal income taxes — with an outsized percentage derived from the top 1% of earners.



Source: State of California/Moody's

There is no question that California's resiliency has been enhanced — highlighted by the retirement of the "wall of debt" and a build-up of reserves — but risks remain. For example, according to a recent report by Standard & Poor's, a "moderately severe recession" could result in a "revenue shortfall of $19.5 billion," exceeding the proposed fiscal 2020 BSA balance of $16.5 billion and equal to about 13.3% of the proposed $147 billion general fund budget/May revision.

Looking ahead, what factors will Bessemer be scrutinizing?

Given that California has already garnered voter approval for extending the temporary income tax increase through 2030, it will be extremely important to monitor the state's financial management practices — especially in light of the new gubernatorial administration and the likelihood of slowing state economic growth.

The pulse of the electorate is also important. The state has a very active voter initiative process that, for decades, has compromised California's financial flexibility (e.g., on the local level, the strict constitutional property tax limits dictated by the "granddaddy" of initiatives — Proposition 13, and on the state level, two-thirds legislative approval for revenue increases).

In addition, management of post-retirement liabilities, the impact of federal policy (e.g., the newly imposed SALT deduction limits and prospective changes to the Medicaid program, such as block-granting), and the effects of climate change all warrant monitoring. An example of the latter is the increasing severity of wildfires; earlier this year, given massive projected liabilities, Pacific Gas & Electric once again declared bankruptcy — its 2001–2004 bankruptcy resulted in above-market electricity prices through 2012.

Our Views on Investing in California

Taking into account the State of California's credit volatility/income tax scheme, how does Bessemer seek to maximize after-tax income for California clients and, at the same time, select bonds that will maintain credit quality and value across the economic cycle?

Synthesizing the relevant credit information discussed above — including the state's revenue structure as well as constitutionally imposed revenue limits on the state/local level — Bessemer has identified various sectors of the California market that tend to exhibit less correlation (from a credit standpoint) with the State of California. Examples include (but are not limited to) the following:

- **Public higher education bonds**: The bonds are secured by a variety of revenues (including tuition/fees); the systems (California State University and the University of California) have solid demand metrics and serve an important economic function.
- **Essential enterprise revenue bonds (e.g., water/wastewater)**: Issuers benefit from the ability to increase user charges to cover expenses (including debt service) as these charges are not subject to the constitutional limits imposed on California property taxes/other revenues.
- **Community college district bonds**: The districts benefit from constitutional funding priority and have greater flexibility to cut expenditures than K-12 school districts (e.g., by reducing course offerings and limiting enrollment).
- **Basic aid school district bonds**: Wealthy districts that are not dependent on the state for funding/subject to state per pupil revenue limits; these districts often benefit from voter approved parcel taxes and community foundations that bolster their revenue bases.

When attractive from a return standpoint, Bessemer seeks out and purchases California bonds in these (and other less correlated) municipal sectors. However, the credit and trading teams continually monitor various markets searching for overlooked pockets of value *in all sectors* for California clients.

For example, the team recently noticed that refunded municipal bonds (i.e., bonds secured solely by escrow accounts invested in full faith and credit U.S. government and/or government agency securities, arguably the most secure bonds in the municipal market) provided relative value as compared to certain California issues that had not been refunded. Confirming this unexpected insight, a refunded Bay Area Toll Authority/BATA holding, scheduled for redemption on 4/1/2023, was recently evaluated at a 1.33% yield. In comparison, Fremont Union High School District bonds maturing 8/1/2023 yielded 1.27%.

Although the Fremont bonds are rated triple-A, the credit quality of the BATA bonds is far stronger; the BATA bonds are secured by an escrow account invested in U.S. Treasury securities, while the Fremont bonds are secured by the district's property taxes. Rendering refunded bonds even more enticing is their scarcity — the TCJA sharply curtailed the ability of municipalities to refund outstanding debt. Best of all, the security provided by the escrow accounts should ensure greater price stability if California's economic and/or fiscal outlooks weaken.

In terms of selecting the most appropriate bonds for California clients, it is important to debunk a widely held belief: In-state bonds (i.e., bonds exempt from both federal and California state income taxes) provide the best after-tax return for California residents. This is not always the case. What many investors fail to realize is that prices of bonds in high-tax states are often inflated. The reason: Residents of these states want to avoid paying state income taxes (leading to a supply-demand imbalance) and have bid up the price of in-state bonds (thereby reducing the after-tax yield).

Astute investors can take advantage of this misconception. When yields on out-of-state municipal bonds (and/or bonds that are federally taxable) are competitive, these bonds can offer an attractive alternative for residents of high-tax states. And, as a bonus, out-of-state bonds offer geographic diversity — a distinct plus in California, where credit quality (and bond prices) can be quite volatile. To avoid the pitfall of overpaying for a California bond offering in-state exemption, returns are compared with out-of-state fixed income alternatives to determine the greatest value.

Finally, in identifying bonds for client portfolios, Bessemer's closely aligned team of analysts and portfolio managers (including taxable) are in constant communication sharing their latest insights regarding both credit and the market. This is particularly important in a state such as California, where close oversight is crucial.

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