Active Insights Podcast – Ziegler's Eco Muni Strategy: Seeking Competitive Municipal Bond Returns Through Financing Critical Sustainable Infrastructure

Diane Merritt:

Welcome to North Square Investments Active Insights Podcast. North Square Investments is dedicated to bringing differentiated active investment strategies to financial advisors and investors through our multi-boutique asset management platform.

Today, Mark Goodwin, Chief Executive Officer of North Square Investments, and Bill Fitzgerald, Senior Portfolio Manager with Ziegler Capital Management will discuss Ziegler's Eco-Muni strategy, which seeks competitive municipal bond returns through financing critical sustainable infrastructure. Ziegler Capital Management partners with North Square for distribution of their Eco-Muni investment strategy. Mark and Bill, we look forward to your discussion.

Mark Goodwin:

Thanks. As you mentioned, at North Square, we seek out best in class active managers and our partners at Ziegler Capital Management have a unique approach to environmentally focused investing utilizing tax efficient municipal bonds. Bill, we mentioned your Eco-Muni strategy and that term may be unfamiliar to many investors. Could you begin our conversation with a basic description of the strategy?

Bill Fitzgerald:

Sure, Mark. This is an investment strategy for high net worth investors who are interested in environmental sustainability and earning tax-free income. The purpose of the strategy is to finance infrastructure that preserves or restores our natural resources, what we call natural capital. The reality we all live with is that in order to grow the economy and generate wealth, we need to consume natural capital, energy, water, the atmosphere and habitat, and these are finite in supply. The natural capital that our generation consumes today will not be available for the generations that follow. At its core, this is what the act of investing is about. We make investments that bring about a better future and leave a legacy that supports our children and our grandchildren.

In our investing, we focus on infrastructure because it is through infrastructure that we as humans interact with the environment. When we put a building in the ground or a power plant or some other piece of infrastructure, it may be there for 40 years or more. So we should only put our money into infrastructure that optimizes the relationship between our human needs and the natural environment. In some cases, restoring the natural environment and building infrastructure are mutually beneficial.

Eco-Muni invests in the municipal bond market where over 40% of all infrastructure in the United States is financed. Our investors direct their investment capital toward environmental sustainability and earn income that is free from federal taxation. In doing so, we strike a balance between generations that offers financial benefit today and environmental benefit to future generations.

Mark Goodwin:

Bill, the municipal bond market provides financing for a myriad of different projects, programs, and activities. How do you screen this universe of municipal bonds for projects that may be suitable from an environmental standpoint?

Bill Fitzgerald:

What makes Eco-Muni different is that it is e-first, meaning Environment First. Unlike most investment strategies that screen for financial factors first and consider environmental factors at the back end of the investment process, we begin our investment process by screening for environmental factors. And by doing so, we create a subset of the most environmentally impactful municipal bonds. After we identify these high impact bonds, then we evaluate for financial credit worthiness.

Mark Goodwin:

What are some of the key characteristics you are looking for?

Bill Fitzgerald:

Well, our e-first approach is influenced by Paul Hawken, an economist whose unique insight was that our economy is driven not just by human capital, physical capital, and financial capital, as often discussed in classical economics, but it is also driven by what he calls natural capital. He classifies natural capital into four different categories, energy, water, atmosphere, and habitat. In generating economic growth, we consume these four sources of natural capital. The problem is they are finite in supply. We can't create more, so we need to use them carefully and preserve and restore them. So when we evaluate a municipal bond for investment, our first step is to evaluate the degree to which the infrastructure preserves or restores each of the four sources of natural capital.

Mark Goodwin:

Thanks, Bill. What areas are you focused on when you're screening projects?

Bill Fitzgerald:

We ask three main questions. Number one, what does science tell us about how effective the technology of the infrastructure will be in preserving or restoring natural capital? Number two, is it repeatable so that it's not just a one-off solution? And number three, is it scalable? Can the infrastructure do what it is supposed to do at a scale that's large enough to match the size of the challenge of climate?

Mark Goodwin:

Once you've narrowed down the pool of potential investments, what's your process to evaluate each specific project to determine if it warrants further financial analysis?

Bill Fitzgerald:

Well, in the next step of the process, we assign a score to the infrastructure project between a positive 10, which refers to infrastructure that fully restores the source of natural capital to a negative 10, which completely consumes or destroys the source of natural capital. The terms that we use to describe this are thick and thin. Thin infrastructure refers to projects that just meet the minimum standards defined by regulation for protecting the environment. And current minimum standards aren't truly sustainable nor do they promote the change that is necessary to achieve a sustainable relationship between humans and nature.

In contrast, thick infrastructure strives to achieve a sustainable relationship between humans and nature. It seeks to restore natural capital to its original state. In our process, bonds need to achieve a minimum threshold score of a positive five to move forward to the stage of financial analysis, but the thicker the better. The ultimate goal of our investment approach is to direct investor capital to the thickest infrastructure while providing a competitive return for our investors. That's what Eco-Muni accomplishes.

Let me offer you an example to illustrate this e-first approach. The city of San Diego Water System. San Diego draws its supply of water from the Colorado River, which has been in drought condition for the past 23 years. Their solution is to construct a water plant that is capable of purifying treated waste water so that it can be used as drinking water. It's an infrastructure solution that recycles their drinking water in a closed loop, preserving and restoring the city's water supply. We score this project a nine of a possible 10, and the bonds are secured by payments on water bills and received a AA credit rating from Standard and Poor’s, a high quality, thick, infrastructure investment.

And one final point. For those bonds that meet our thickness threshold, we continue to evaluate their impact on natural capital and adjust their thickness scores up or down depending on whether the projects meet our expectations.

Mark Goodwin:

Bill, after applying your environment first approach, thick and thin, how do you then evaluate each credit and then select specific investments?

Bill Fitzgerald:

Well, for those that meet our thickness criteria, we analyze the financial strength of the local government borrowers, which means evaluating their sources of payment, their debt burden, the strength of governance, and the importance of the sustainable infrastructure to the community. After many years of credit research on municipal bonds, we find that it is sustainable infrastructure projects that are usually the critical infrastructure of the community. Water systems, waste treatment systems, energy systems, and the infrastructure is a high priority for local governments.

Mark Goodwin:

Bill, we've heard a lot of talk about green bonds in the municipal space and in general, can you talk about how the Eco-Muni strategy straddles this world or how we should think about Eco-Muni in the context of green bonds?

Bill Fitzgerald:

Sure, Mark. Green bonds are kind of a loose definition used in the market to describe a bond that has some environmental impact. The reality is there's no single definition or standard for what an infrastructure project will provide an environmental benefit. And often the green bonds in the marketplace are self-labeled by the issuers, or they're valued by an expert, but the criteria is not transparent. So, in our experience, we've looked at a lot of green bonds during our time analyzing sustainable infrastructure projects, and only about 20% of the green bonds that we evaluate meet our fixed sustainable criteria.

Mark Goodwin:

How do the bonds you select typically compare to similar credits that do not fit your environmental criteria?

Bill Fitzgerald:

That's an interesting question. We've been applying our Eco-Muni analysis to municipal bonds for about five years, and so we've looked at a lot of bonds and sifted through a lot of data. What we distill from the data is that the bonds that are the thickest tend to be on the higher quality part of the spectrum, and therefore lower risk from a credit standpoint than the universe of municipal bonds as a whole. And this makes sense for two reasons. First of all, they are concentrated in sectors that local governments considered essential services, electricity generation, water delivery, waste management, mass transit, construction of new buildings.

The sources of payment vary from payments on utility bills to general property taxes. Infrastructure systems that involve energy, water, preservation of habitat are considered some of the most important services that a local government delivers. When it comes to the consequences of climate change, most local governments are not taking any chances. This is the high quality part of the municipal bond market.

Mark Goodwin:

Bill, are you finding sufficient depth in the pool of suitable investments to allow you to be selective on the underlying credit and the financial terms of the investment?

Bill Fitzgerald:

Yes. There's a strong supply of bonds that meet our e-first criteria. We find thick sustainable infrastructure in the energy sector, the water sector, waste management, mass transit, higher education and projects involving residential and commercial real estate development. These sectors make up a large proportion of the municipal bond market, and given the increasing number of extreme weather events that are a consequence of climate change, we're seeing meaningful growth in the number of sustainable projects financed in the muni bond market.

Mark Goodwin:

Bill, I'm going to pivot to portfolio construction for a minute. How do you allocate investments to build a portfolio? Can you give us some of the key portfolio characteristics such as duration, yield, credit quality, that you focus on, and are there target ranges for these characteristics?

Bill Fitzgerald:

Yes, sure. We invest in municipal bonds between eight to 12 years to maturity. The average maturity of the composite portfolio is 10 years. That translates to a modified duration of around seven and a half, and we'll keep the duration in a range between six and eight. The yield on the portfolio will depend on changes in the municipal bond markets, but as of today, the yield on the portfolio is 3.75%, which is free from federal income tax. That is a taxable equivalent yield of a little over five and three quarters percent for an investor in the 35% income tax bracket.

In terms of credit quality, we purchase investment grade bonds, which means bonds in the four highest credit rating categories ranging from BBB to AAA. The average credit quality of Eco-Muni holdings is AA. So the opportunity set that our e-first approach generates leads to a high quality portfolio of municipal bonds that directs investor capital to the most environmentally impactful or thickest infrastructure projects.

Mark Goodwin:

Bill, how do you look to diversify the portfolio regarding individual position sizes, project types, regions, special revenue versus general obligation, et cetera?

Bill Fitzgerald:

We diversify credit risk to local government issuers by limiting position sizes to 5% of the portfolio, with the exception that we can invest more than 5% in an individual issuer for up to 25% of the market value of the account. This is consistent with the diversification requirements of mutual funds that are regulated by the 1940 Act. Typically, approximately 75% of the portfolio will be in revenue bonds, and 25% will be in general obligation bonds. The sectors with the greatest quantity of bonds and the greatest opportunities are the power sector and the water sector. On average across accounts we'll invest between 15 and 25% to each of these sectors. But if we find attractive opportunities, we'll invest up to 35% in one of these sectors.

With regard to geography, we see thick sustainable projects in almost every state, but there are greater numbers of opportunities in states that are along the ocean, East Coast, West Coast, southeast, and there are opportunities in states that face resource scarcity due to climate change such as Texas and Colorado. So Eco-Muni will allocate up to 25% in a single state and may invest up to 50% in the state if the opportunities in the state are numerous.

Mark Goodwin:

Bill, Eco-Muni is a strategy offered as a separately managed account. With this in mind, how accessible are the municipal securities the strategy is focused on, and how liquid is the general market for these securities?

Bill Fitzgerald:

Well, as I mentioned, the average credit quality of the bonds in Eco-Muni is AA. These are among the most liquid bonds in the municipal bond market. With regard to gaining access to bonds that meet the Eco-Muni criteria, there are two ways that we source bonds. The first is the primary market where state and local governments sell new issues into the market. The way this works is local governments announce a date for the sale of the bonds, and they distribute an offering document that we review in our Eco-Muni research process.

The second way that we access muni bonds is in the secondary market where investors buy and sell bonds that were previously issued and they've held in their portfolios. We maintain an approved list of thick sustainable bonds that we've researched in the past, and we track the bonds that other investors are selling that we've already identified and analyzed as thick.

Mark Goodwin:

Thank you, Bill. What would cause you to sell a position or similarly cause a significant shift in your portfolio allocations?

Bill Fitzgerald:

Well, generally, we will manage Eco-Muni with low turnover in the portfolio because I've learned that keeping trading costs low will increase the investment return. We will sell a position if we anticipate a credit problem, or in other words, a challenge to a local government's ability to pay, but this is infrequent. We will sell when the return benefit of the bond from the rolldown of a yield curve subsides a few years before the bond matures. And we'll sell a bond if our thickness score drops below five, which is our minimum threshold for a bond, making it onto our buy list. We may also sell a bond if we have an opportunity to buy a new bond whose thickness score is several notches higher than the one that we have in the portfolio, which would make the portfolio thicker, but we'll only do this if the return potential is at least as good as the bond in the portfolio. These are the reasons why we may make a change in the portfolio mix.

Mark Goodwin:

Bill, as we have been discussing, the Eco-Muni strategy looks to address core societal needs without compromising returns in the municipal bond space. How do you see the strategy best fitting in an investor's portfolio?

Bill Fitzgerald:

Eco-Muni is for investors who desire tax free income from municipal bonds, who want to counterbalance the risk of the equity market, which high grade bonds have been effective at doing for a long period of time. And it's for investors who want to maximize the positive impact of their investment capital on the environment, these are the three investment goals that Eco-Muni can achieve for investors.

Mark Goodwin:

Bill, thank you for joining me today. This has been a great discussion.

Bill Fitzgerald:

Yeah. It's my pleasure, Mark. Thank you.

Diane Merritt:

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Definitions of key terms in this Podcast:

Duration measures a bond's or fixed income portfolio's price sensitivity to changes in interest rates. Typically, when interest rates rise, the higher a bond's duration, the more its price will fall. Time to maturity and a bond's coupon rate are two factors that can affect a bond's duration.

Average Credit Quality provides a "snapshot" of a fixed income portfolio's overall credit quality—it is an average of each bond's credit rating, adjusted for its relative weighting in the portfolio.

Revenue Bonds are a category of municipal bond supported by the revenue from a specific project, such as a toll bridge, highway, or local stadium. A revenue bond repays creditors from income generated by the project that the bond itself is funding, such as a toll road or bridge.

General Obligation Bonds are municipal bonds backed entirely by the credit and taxing power of the issuing jurisdiction rather than the revenue from a given project. General obligation bonds are issued with the understanding that a municipality will be able to repay its debt obligation through taxation or revenue from projects.

The **Yield Curve** is a term used to describe a "normal" curve in which short-term debt instruments have a lower yield than long-term debt instruments of the exact same credit quality. This gives the yield curve an upward slope. This is the most often seen yield curve shape, and it's sometimes referred to as the "positive yield curve." Analysts and market observers study the slope of the yield curve for indications about how future short-term interest rates will trend. When there is an upward sloping yield curve, this oftentimes indicates an expectation across financial markets of higher interest rates in the future; a downward sloping yield curve is thought to predict lower rates.

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