Investing Bonds Proceeds in Today's Interest Rate Environment

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Today's Presenters

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Agenda

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01 ECONOMIC UPDATE

02 PROJECT FUND INVESTING

03 TAX EXEMPT BONDS: ARBITRAGE AND YIELD RESTRICTION

04 TODAY'S ENVIRONMENT: CHALLENGES AND STRATEGIES

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Economic Update

Fed Funds

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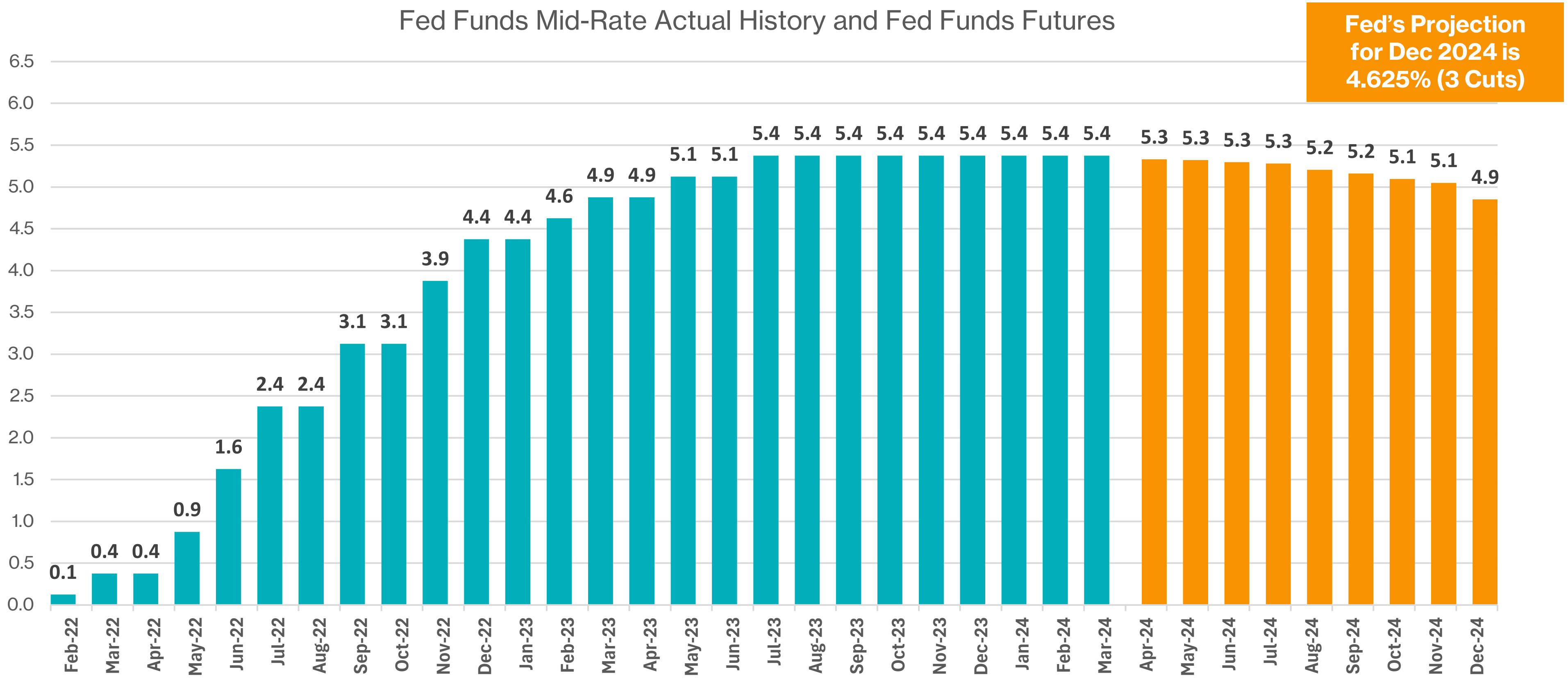
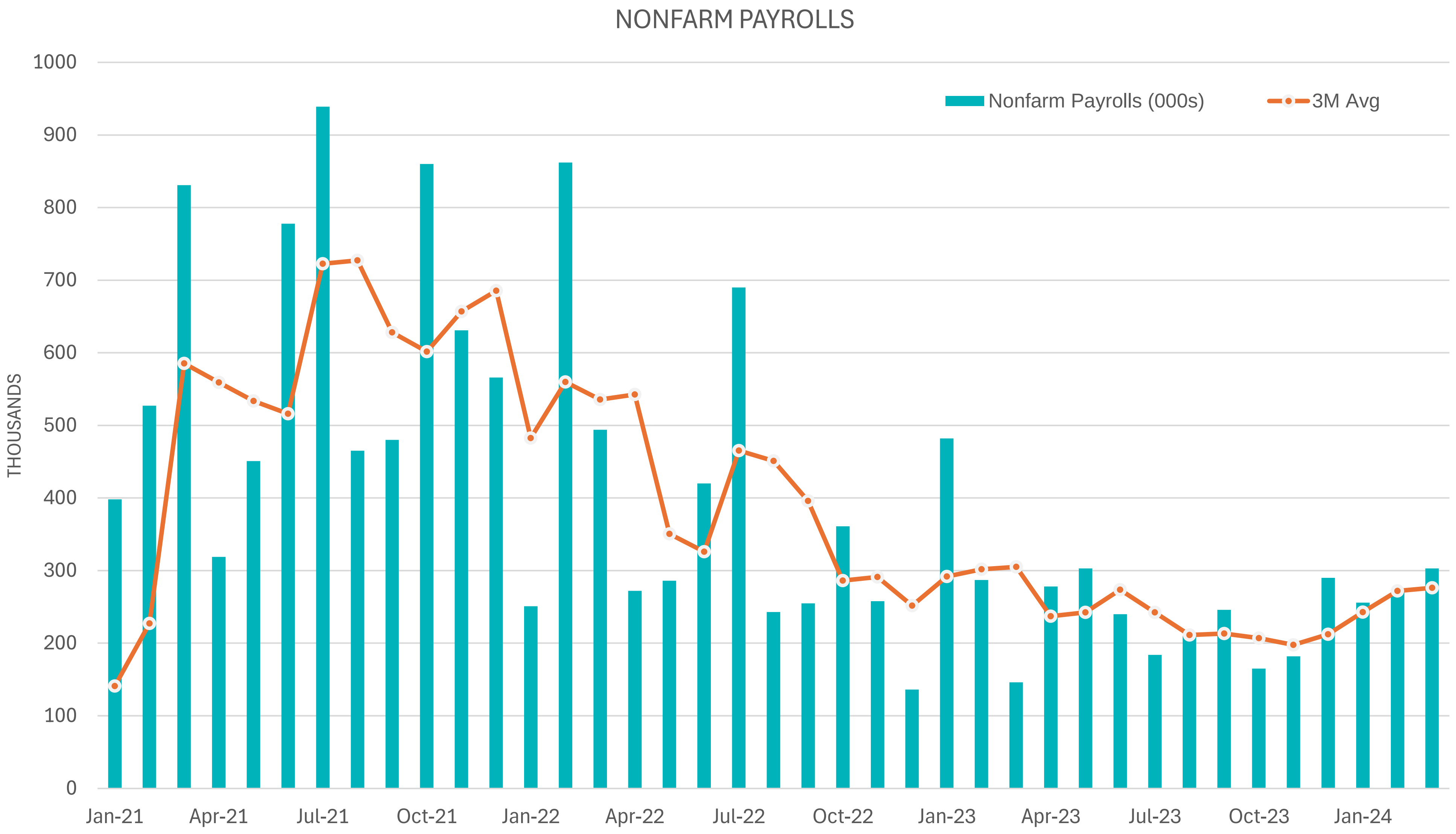


- The Fed Funds futures market is also expecting about 2 cuts this year. However, the futures market was projecting about 7 cuts back in January 2024.
- The futures market is currently expecting the first cut to occur at the September 2024 meeting.

Meeting Date	1/31/24	3/20/24	5/1/24	6/12/24	7/31/24	9/18/24	11/7/24	12/18/24
Hike/Pause/Cut	Pause	Pause	Pause	Pause	Pause	Cut	Pause	Cut
Basis Point Change	0	0	0	0	0	(25)	0	(25)
Fed Funds Mid Rate	5.375	5.375	5.375	5.375	5.375	5.125	5.125	4.875

SOURCE: BLOOMBERG AS OF 4/25/24

Job Market



- The U.S. employment sector remains robust.
- The U.S. economy has experienced 39 consecutive months of job growth.
- The 3-month average job growth has accelerated since the later part of last year.
- Job openings have declined but remain well above pre-pandemic levels.
- The healthy job market has helped keep consumer spending at a high level.

SOURCE: BLOOMBERG

Inflation

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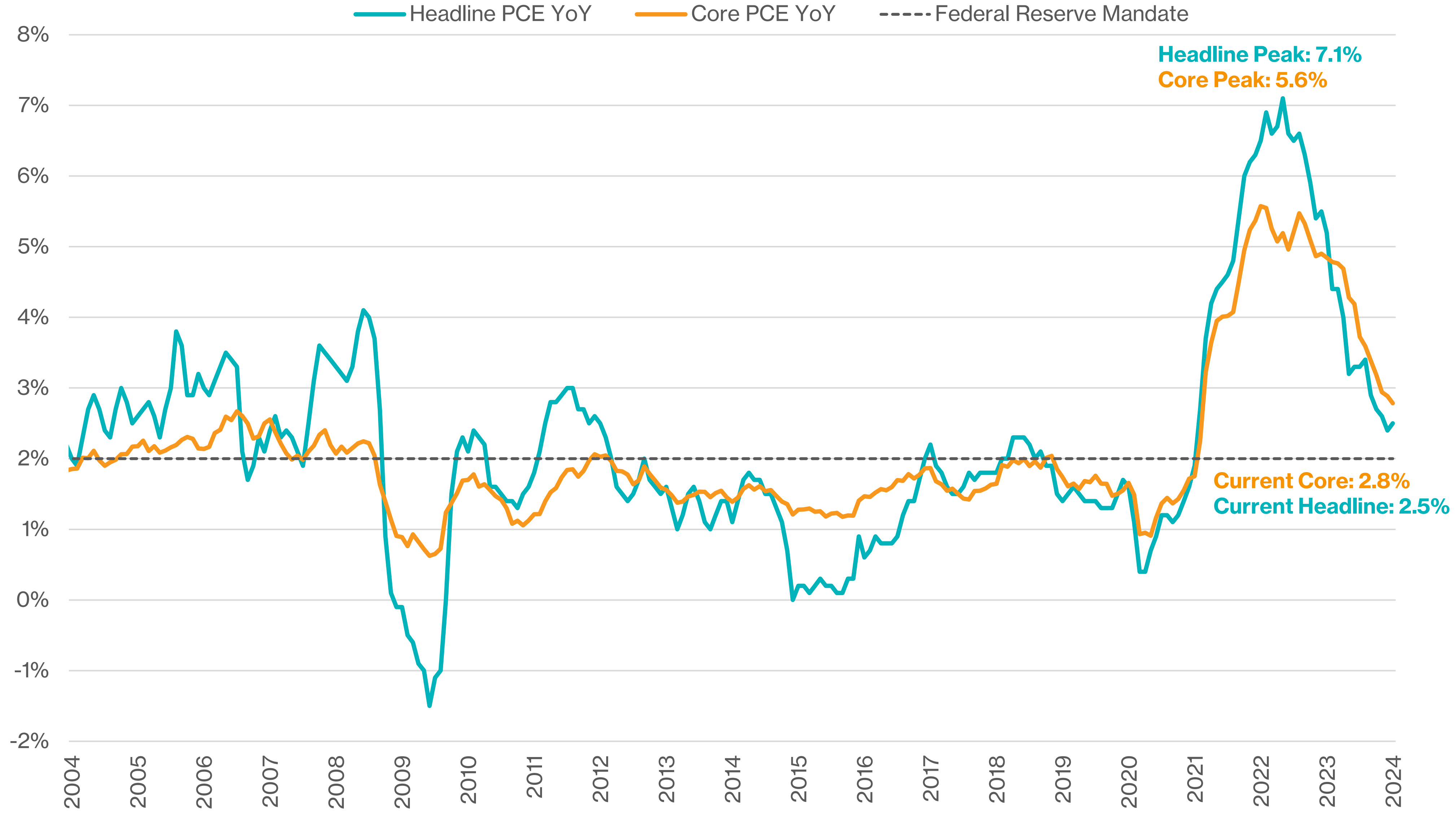

- The Consumer Price Index (CPI), has shown signs of stickiness the past six months, averaging about 3.3% since last September.
- The Fed's preferred inflation metric, Core Personal Consumption Expenditure (excluding food and energy prices), continues decelerating, but is still above the Fed's 2% target level.

SOURCE: BLOOMBERG

Consumer Expectations

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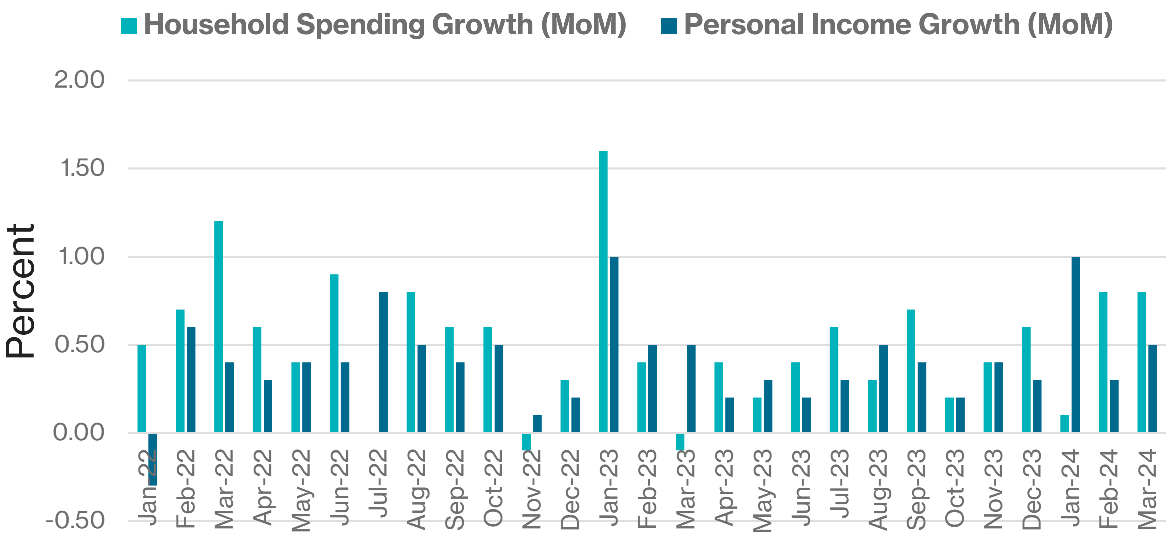
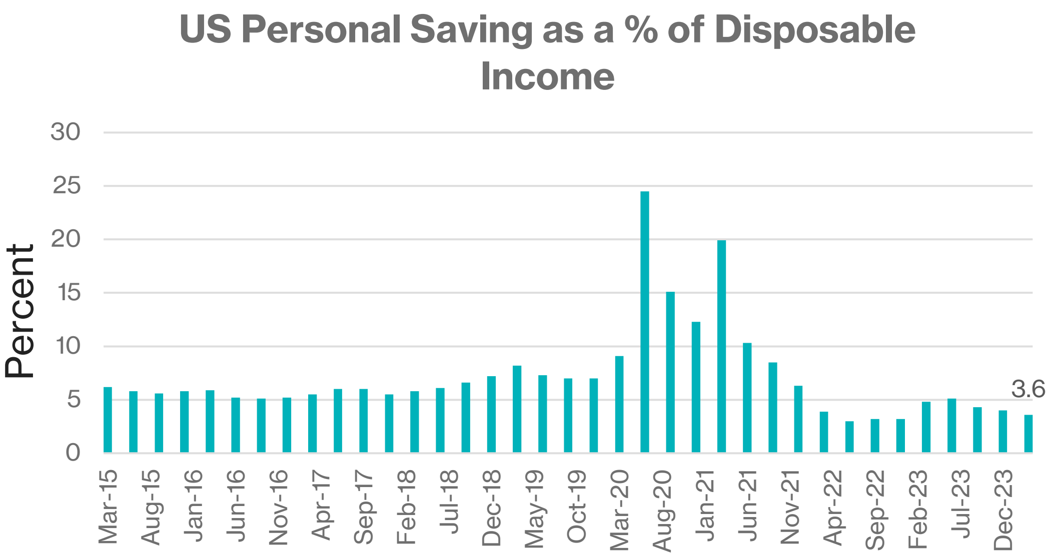
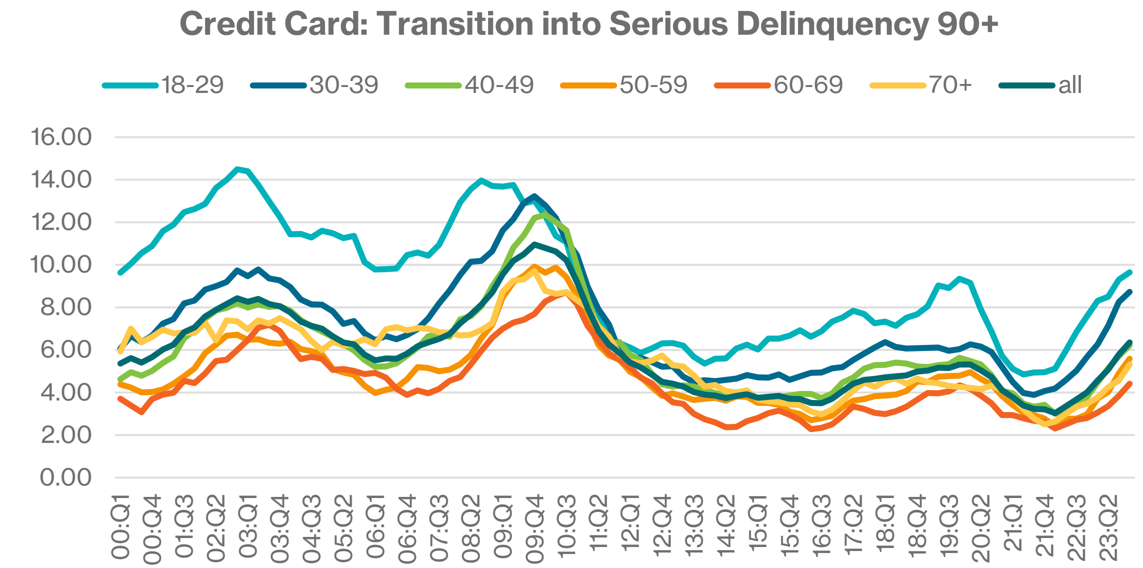
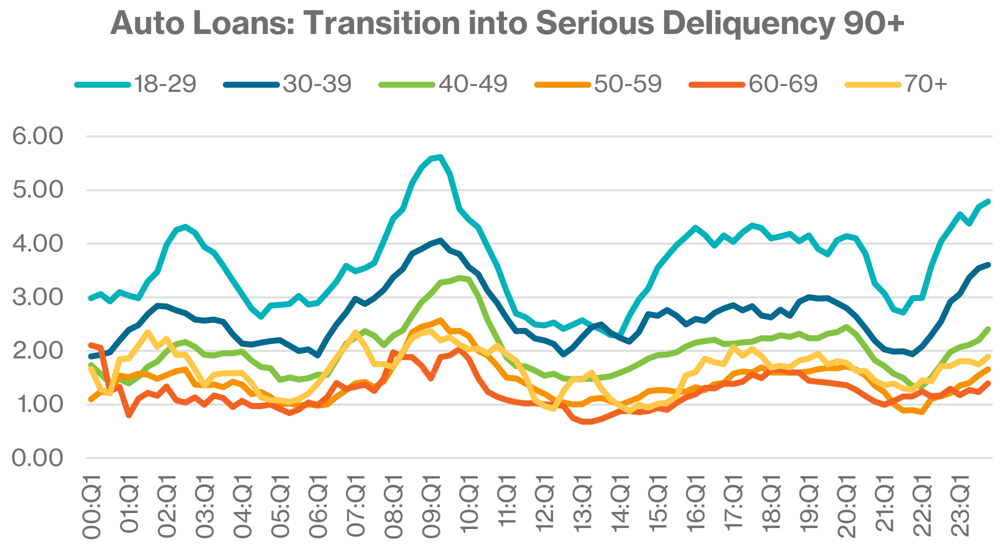




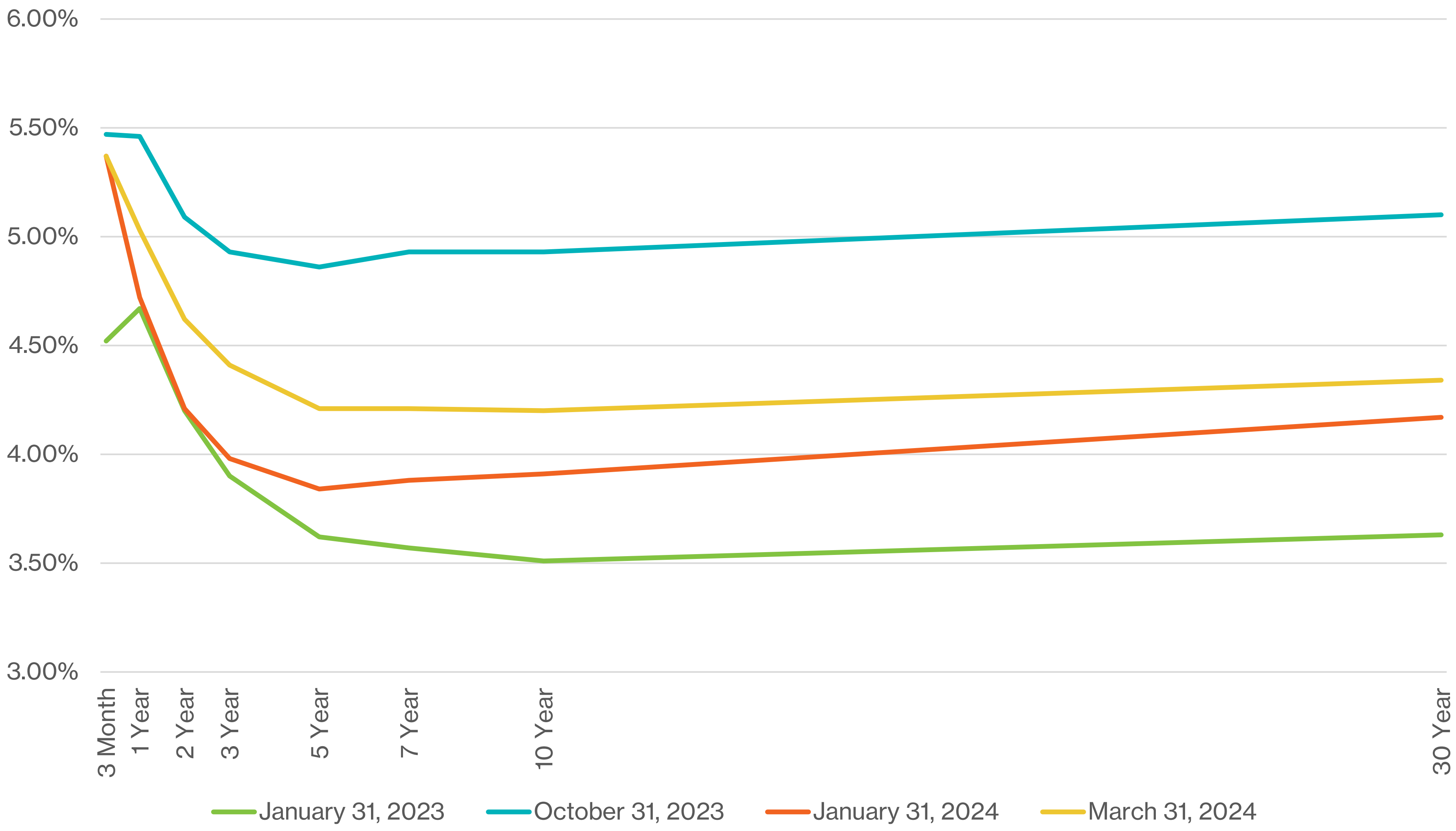




BLOOMBERG, BLS, NY FED

Interest Rates

US Treasury Yield Curves



SOURCE: BLOOMBERG

- With growth (GDP) estimates slowing this year and inflation declining materially from the summer 2022 highs, intermediate and longer-term rates have dropped from last fall's peaks.
- Intermediate and longer-term rates are generally much more correlated to growth and inflation expectations.
- Short-term rates, such as the 3-month treasury, generally have a high correlation to the Fed Funds rate.

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Poll Question

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Project Fund Investing

Project Fund Investing

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1. Work with issuer and construction manager to understand cash flow requirements
2. Review investment policy, economic conditions, and investment opportunities
3. Formulate and execute investment strategy
4. Ongoing discussions with issuer on the status of project; adjust strategy as needed

Portfolio Right-Sizing

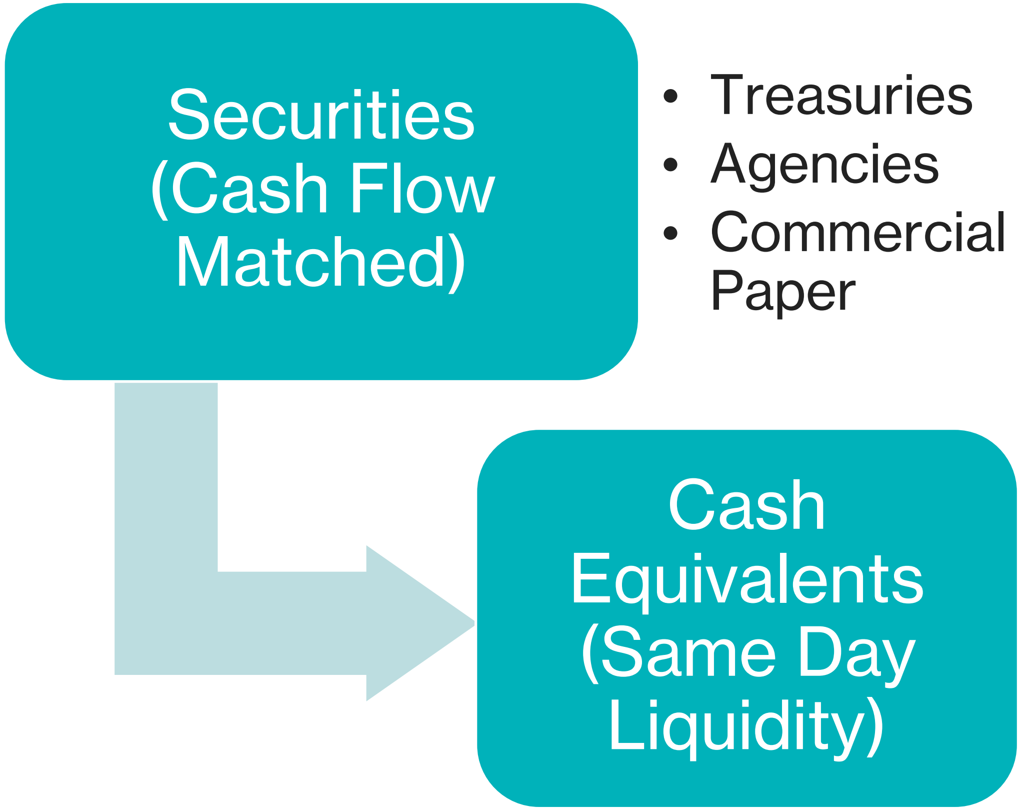
CASH

LIQUIDITY RESERVE

CORE INVESTMENT PORTFOLIO

Project Fund Allocations

- Ensure funds are available to meet project expenditures, while maximizing interest earnings



- Treasuries
- Agencies
- Commercial Paper

- Local Government Investment Pools
- Money Market Mutual Funds

Hypothetical School District– 2024 Bond Issue Schedule

Projects	Amount	Start	Completion
High School Rebuild	$125,000,000	Winter 2023	Summer 2028
Middle School Rebuild	$115,000,000	Winter 2023	Spring 2028
Security Improvements	$25,000,000	Winter 2023	Winter 2024
Maintenance	$25,000,000	Winter 2023	Winter 2024
Technology Project 1	$3,000,000	Winter 2023	Winter 2024
District Overhead Costs	$2,000,000	Winter 2023	Winter 2024
Technology Project 2	$10,000,000	Winter 2023	Winter 2024
New Construction Project C	$10,000,000	Winter 2023	Summer 2028
Contingency Costs	$35,000,000		
Total	**$350,000,000**		

Estimated Drawdown Schedule – 2024 Bond Issue

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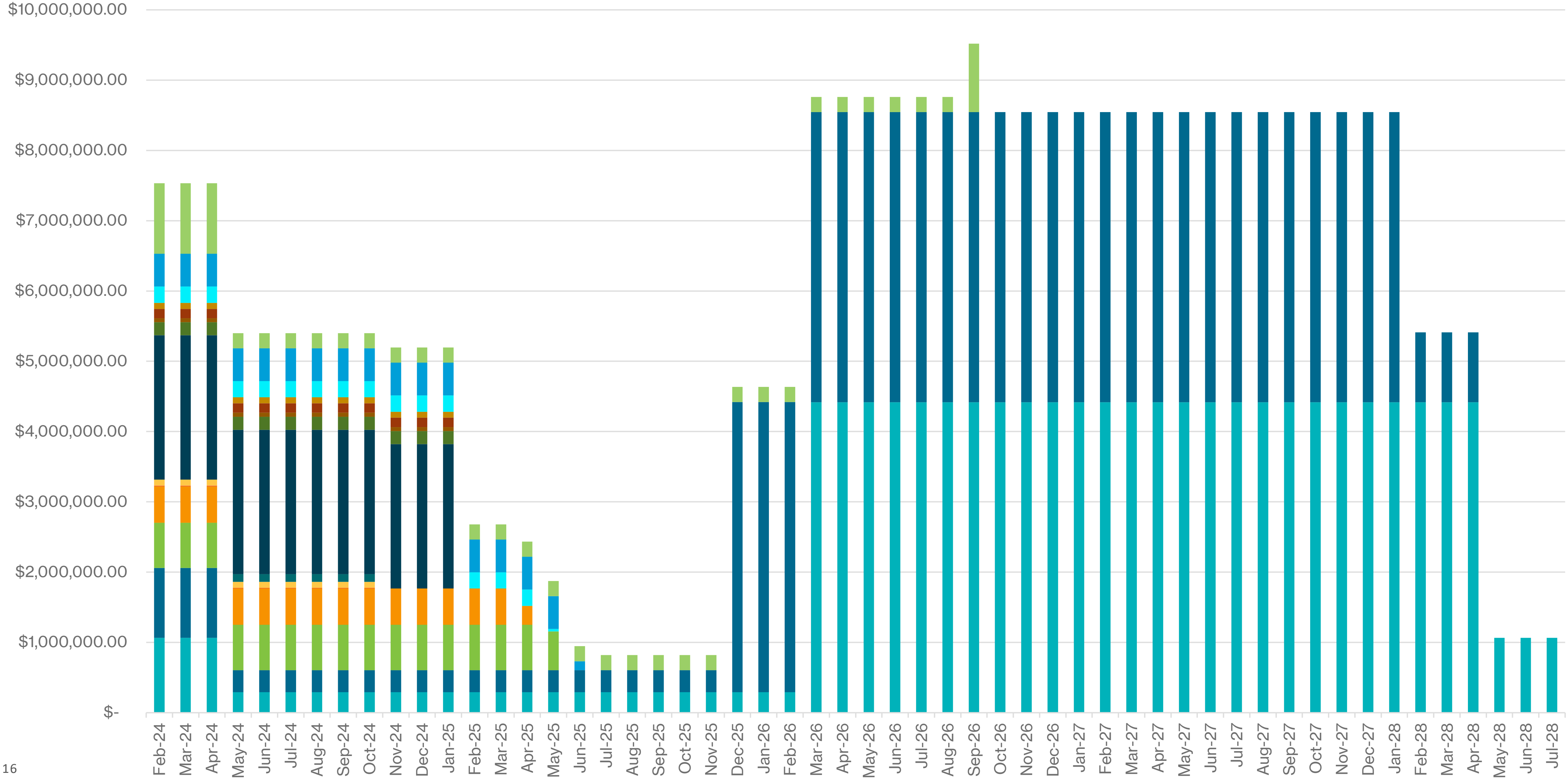
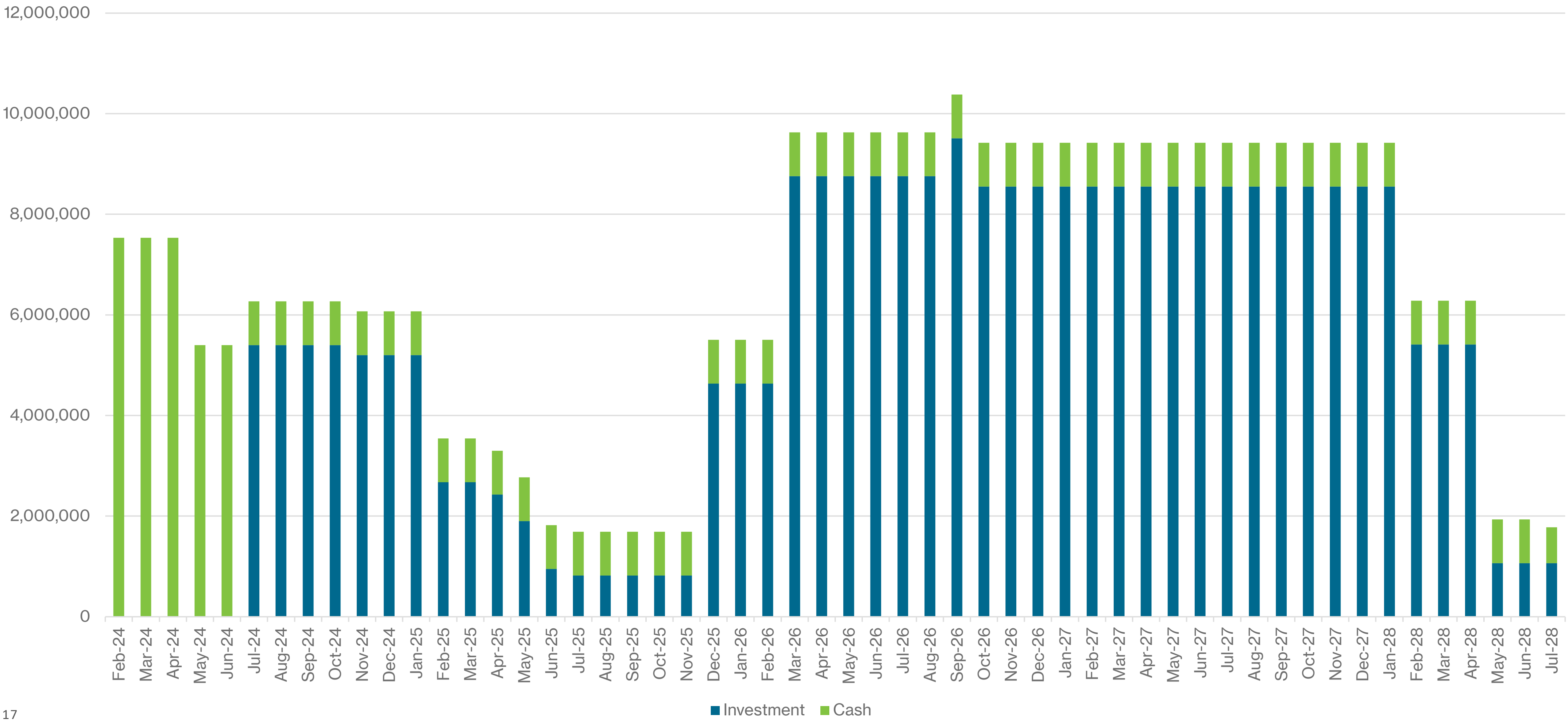


Investment Schedule

Cash: $75,870,000
Securities: $284,130,000



Opportunity to Create Longer-Term Certainty

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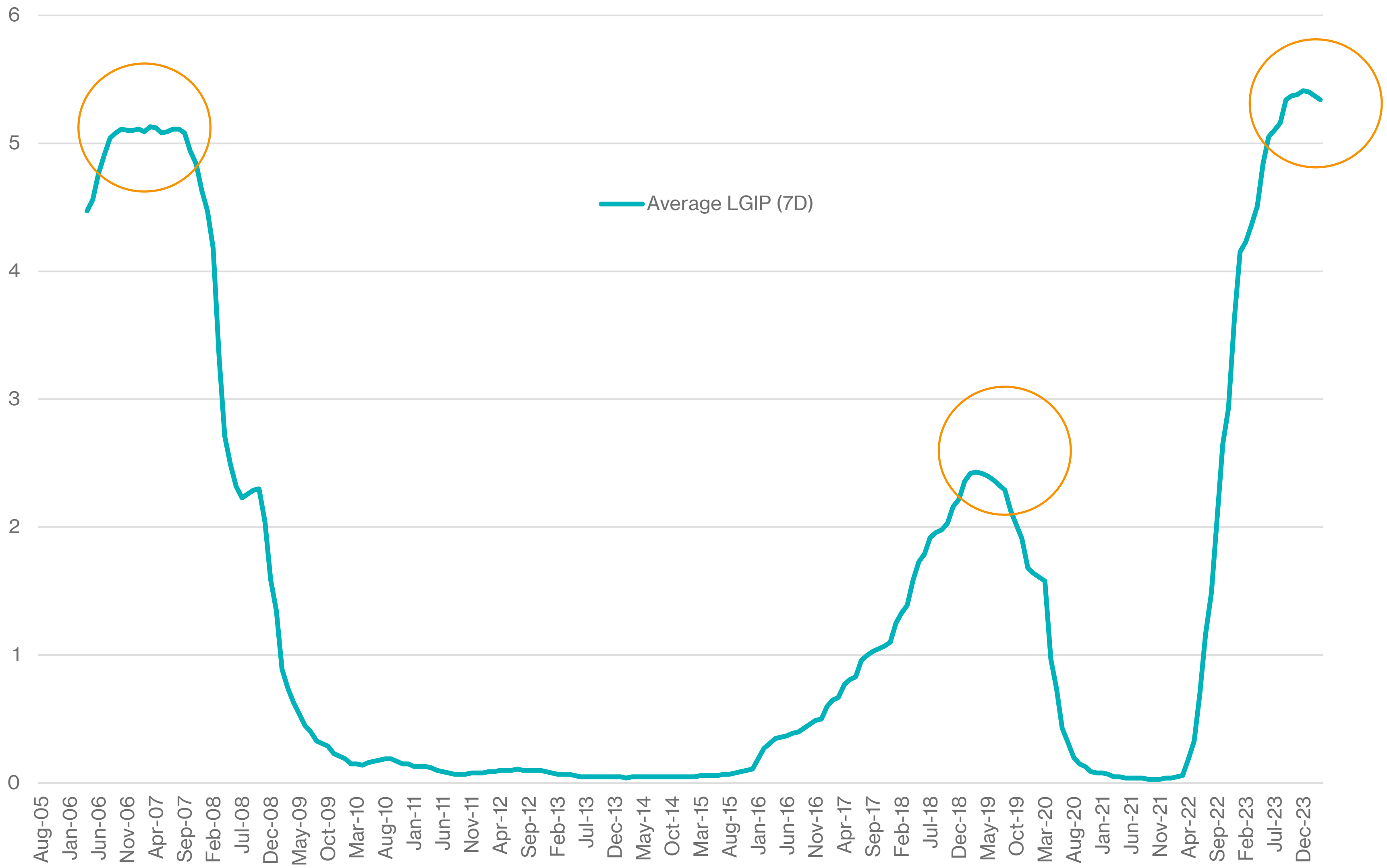

- Short-term interest rates topping out?
- Opportunity to lock in high interest rates for the long-term
- Creates budgetary certainty for the long-term

AS OF 12/31/2023 SOURCE BLOOMBERG. Average LGIP represented by LGIP7D Net Index.

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Tax-Exempt Bonds: Arbitrage and Yield Restriction

Today's Interest Rate Environment

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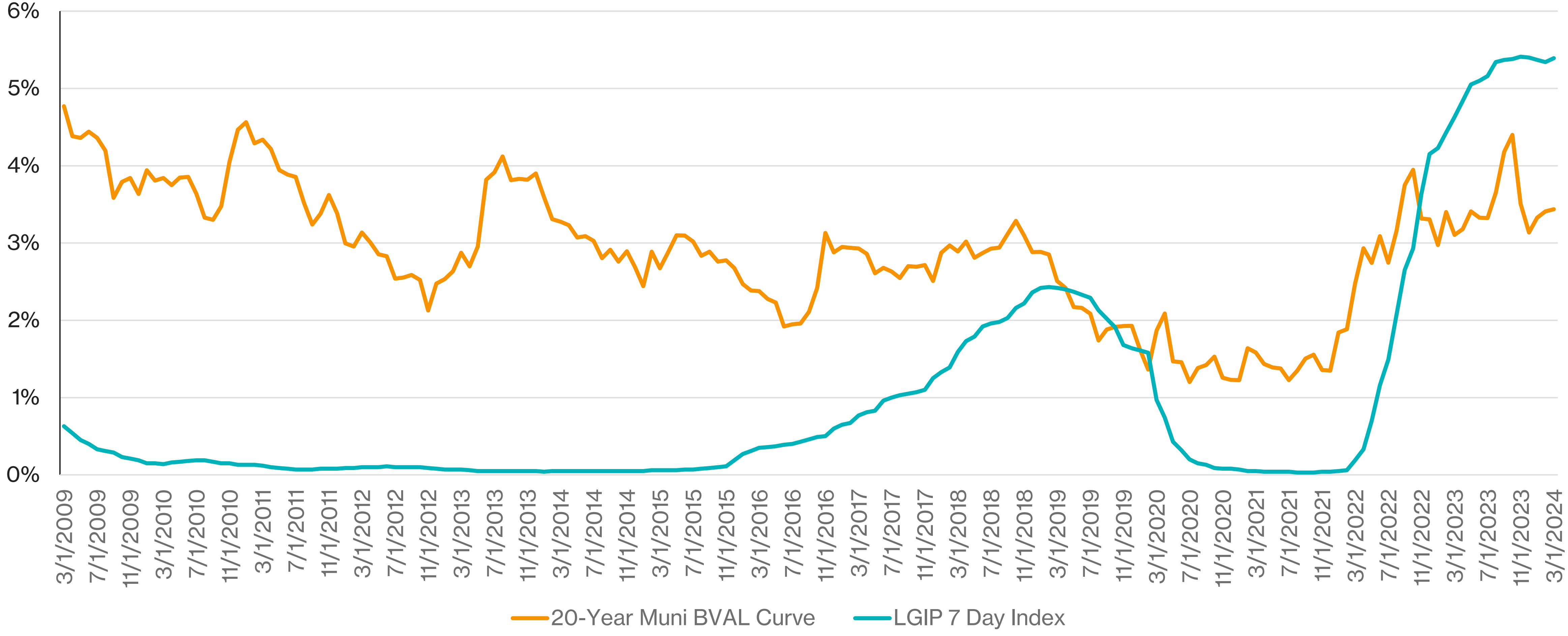
Long-Term Tax Exempt Rates vs. Short-Term Taxable Rates



SOURCE: BLOOMBERG

Tax-Exempt Bonds

What are they? Why are they used?

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- **Tax-exempt bonds:**
  - Tax-exempt bonds are the primary mechanism through which state and local governments raise capital to finance essential public projects.
    - Example projects: schools, roads, bridges, highways, airports, water and wastewater facilities

- **Tax Treatment:**
  - Under the Tax Code, bonds issued by state and local government entities generally bear interest that is excluded from gross income for federal income tax purposes
  - This preferential tax treatment generally results in municipal securities bearing a lower interest rate than taxable fixed income securities (such as corporate bonds).
  - The Federal tax exemption functions as an indirect subsidy to state and local governments: by not taxing the interest on municipal bonds, municipalities receive a lower borrowing rate from capital market investors

Federal Tax Law – Arbitrage Rebate and Yield Restriction

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- The Federal Tax exemption comes with strings attached for state and local governments

- Because the Federal Government is forgoing tax revenue with tax-exempt municipal bonds, the Tax Code is designed to prevent governments from:
  - Issuing more tax-exempt bonds than needed
  - Issuing tax-exempt bonds earlier than needed
  - Keeping tax-exempt bonds outstanding longer than needed

- One of the ways the Tax Code limits the amount of outstanding tax-exempt bonds is through the Arbitrage Rebate and Yield Restriction rules.

- The Arbitrage Rebate and Yield Restriction rules are a “belt and suspenders” approach. They both place limitations on the investment earnings from tax-exempt bond proceeds

Yield Restriction

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- The Yield Restriction rules outline when a public issuer *may invest* bonds proceeds at a yield above the bond yield.

- These rules *do not* address when a public issuer may *keep the excess earnings*.

- The most common exception to Yield Restriction is the three-year temporary period exception for new money project funds.
  - Must expect to spend 85% of proceeds within 3 years
  - Must incur binding obligation to spend at least 5% of proceeds within 6 months of issuance
  - Must proceed with due diligence in spending proceeds
  - Temporary period can be extended to 5 years if it is certified that a longer period is necessary to complete project

- After 3 years, if proceeds are unspent, must make “yield reduction payments”

- The Temporary Period election is made at the time of issuance and is reflected in the Tax Certificate

Arbitrage Rebate

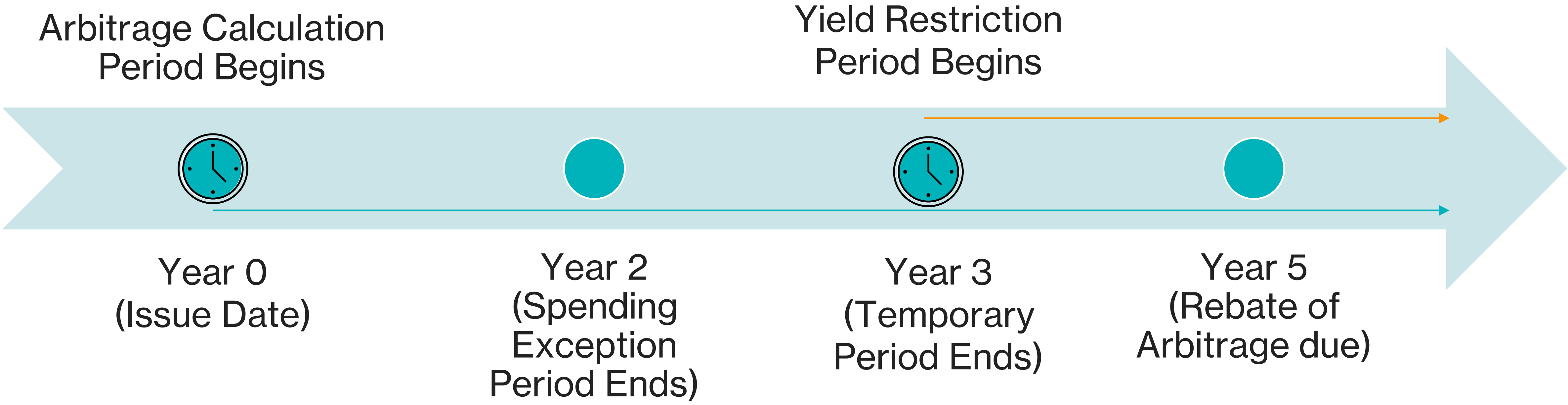
- The Arbitrage Rebate rules determine whether a public issuer *may keep* earnings above the bond yield.
- Arbitrage rebate requires the issuer to pay the U.S. Treasury investment returns earned above the bond yield after five years, unless an exception is satisfied.
- The primary exceptions to arbitrage rebate are the spending exceptions listed below. Other exceptions include small issuer exception (issue less than $5mm in a year) and debt service fund exception.

1) 6-month Exception: No rebate owed if all proceeds spent within 6 months

2) 18-month Exception: issue must spend based on below schedule:
   - 6 months – 15%
   - 12 months – 60%
   - 18 months – 100%

3) 24-month Exception: Only applicable to construction issues and the issuer must spend based on below schedule:
   - 6 months – 10%
   - 12 months – 45%
   - 18 months – 75%
   - 24 months – 100%

How do these rules work together?



Exceptions to Arbitrage Rebate & Yield Restriction

Investments that are excluded from limitations on interest earnings:

- Tax-exempt bonds
- Tax-exempt money funds
- Demand Deposit State and Local Government Securities (SLGS)

SLGS are special obligations of the US Treasury, with a pledge of the full-faith and credit of the United States, designed to assist public issuers with complying with the Arbitrage and Yield Restriction rules.

Two type of SLGS

1) Demand Deposit: One-day certificate of indebtednesss that are rolled daily until redemption. Depending on the size of the redemption, they can be redeemed on 1-3 days' notice.

2) Time Deposit: Time deposit securities with maturities ranging from 15 days to 40 years. Public issuer can select interest rate ranging from 1 basis point below the current matching treasury to 0%.

Demand Deposit SLGS Mechanics

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Characteristics:

- Book-entry form; Non-marketable
- One-day Certificate of Indebtedness
- Interest is capitalized daily on principal and prior accrued interest; paid at redemption
- Rate based on an adjustment of the average yield in most recent 13-week bill auction (reset daily)
- Minimum: $1,000; Maximum: None

Subscription:

- Subscriptions are made through TreasuryDirect's SLGSafe website
- Subscriptions for less than $10 million – 5 calendar days before issue date
- Subscriptions for more than $10 million – 7 calendar days before issue date
- TIN of the "issuer" is needed for subscription

Redemption:

- Redemptions are made through TreasuryDirect's SLGSafe website
- Redemptions for less than $10 million – 1 calendar days' notice
- Redemptions for more than $10 million – 3 calendar days' notice

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Today's Environment: Challenges and Strategies

Case Study #1

- Assumptions:
  - Bonds Issued on April 15, 2020
  - New money construction project
  - Arbitrage yield of 2%
  - Project fund qualified for 3-year temporary period
  - Did not meet rebate exceptions
  - Expect to spend remaining proceeds over next 12 months

- Rebate analysis will be based on earnings since issuance. Negative arbitrage from early years of investments can be used to offset positive arbitrage since rate hikes.

- Yield Restriction began to apply on April 15, 2023. Earlier negative arbitrage cannot be used in yield restriction analysis.

- Demand Deposit SLGS

Case Study #1 - Bonds Issued on April 15, 2020 at 2%

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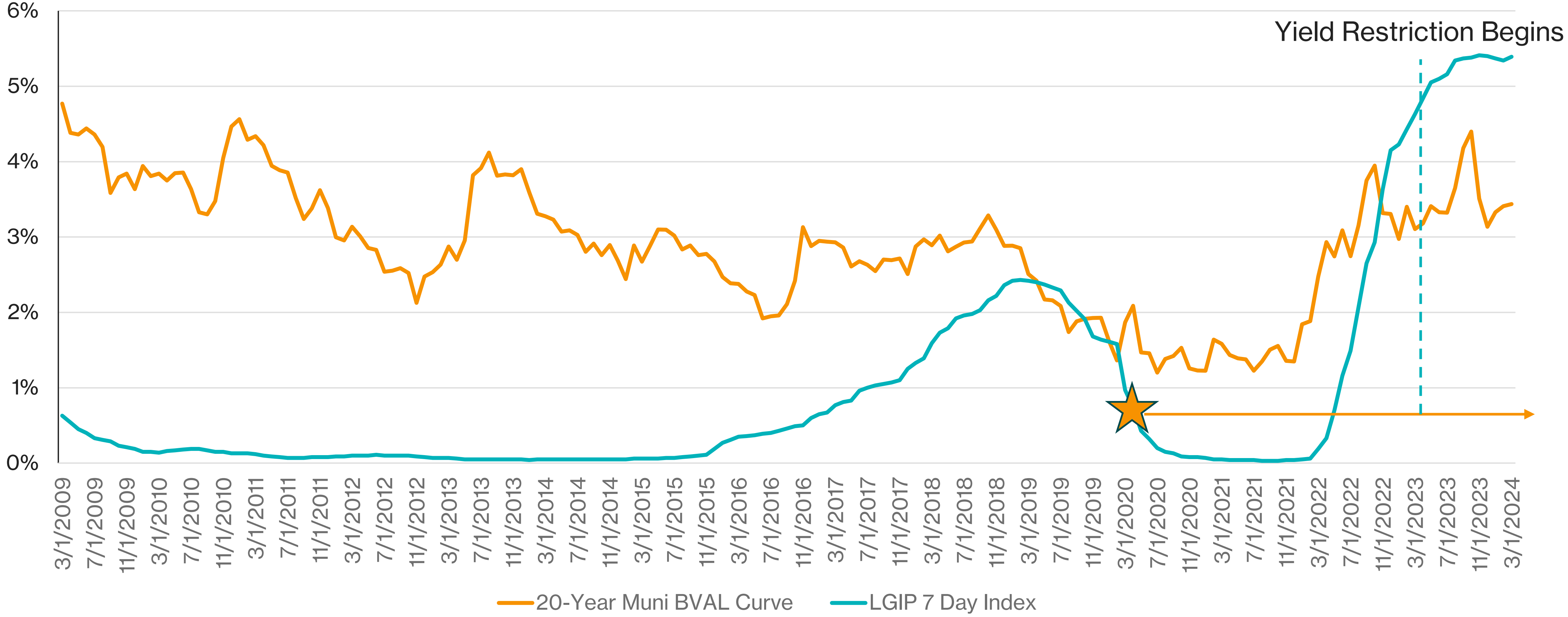

Case Study #2

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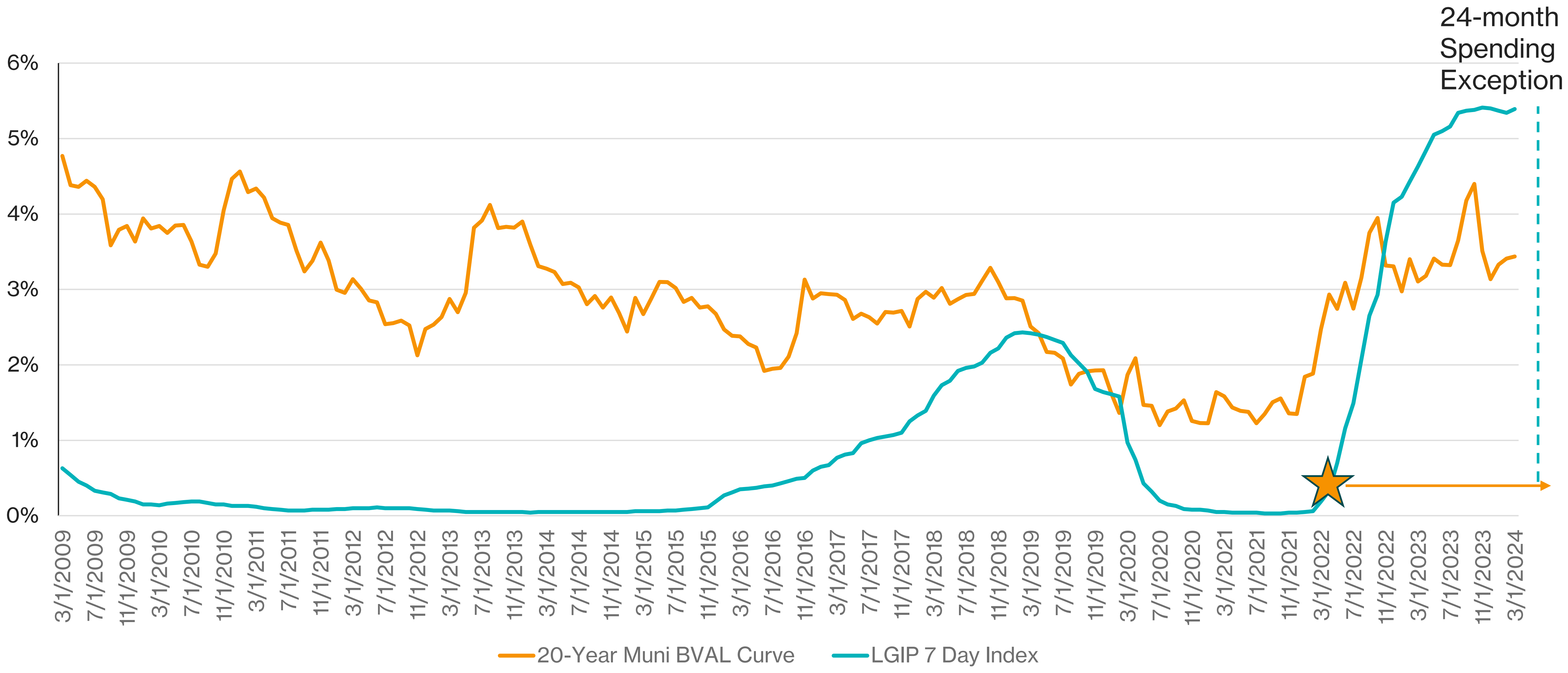
- Assumptions:
  - Bonds Issued on April 15, 2022
  - New money construction project
  - Arbitrage yield of 2.75%
  - Project fund qualified for 3-year temporary period
  - Did not meet rebate exceptions
  - Average investment rate to date of 4%

- Rebate analysis will be based on earnings since issuance. Significant positive arbitrage during first two years since issuance.

- Investment strategy may be driven by expected spend down of unspent proceeds
  - If proceeds expect to be expended over next 6-12 months, SLGS may be appropriate.
  - If spend down expected to occur over longer time frame, continuing to maximize earnings may be prudent.

Case Study #2 - Bonds Issued on April 15, 2022 at 2.75%



Case Study #3 – New Issuance in 2024

- Assumptions:
  - Bonds will be issued on May 1, 2024
  - New money construction project
  - Project fund will qualify for 3-year temporary period
  - Expected bond yield of 3.5%
  - Spend-down not projected to meet rebate exceptions

- Investment Options:
  - Taxable Cash equivalents
    - Pros: Highest rates available
    - Cons: Reinvestment risk and lack of earnings certainty
  - Securities Portfolio:
    - Pros: Rates above bond yield with earnings certainty
    - Cons: Lower rates than cash and less liquidity
  - Demand Deposit SLGS
    - Possible option for liquidity management under certain circumstances

Key Takeaways

- Understand the structuring decisions and tax elections made at the time of issuance
- Monitor spenddown of proceeds and rebate exception compliance
- An arbitrage rebate or yield restriction liability is not a bad thing
- Avoid surprises
  - Work with your arbitrage calculation firm to monitor your investment earnings
  - Ensure sufficient funds are set aside if a material liability as accrued
- Be aware of the full investment toolkit
  - Demand deposit SLGS
  - Tax-exempt municipals
- Optimizing your project fund investments is highly fact specific
- Goal: Maximize the investment earnings that you can retain

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