FIXED INCOME

Do Teachers' Strikes Have Us Picketing California School District Bonds?

March 14, 2019

Jennifer Johnston
Vice President,
Research Analyst,
Franklin Templeton Fixed Income Group®

Two large teacher's strikes in California have made headlines this year, one in Los Angeles and another in Oakland. Neither was prolonged, but both highlight funding concerns in these and other communities. Jennifer Johnston of our Municipal Bond department explains the role investors play in funding public education through municipal bonds.

Public education is viewed as one of the most important services that state and local governments provide. In fact, many state constitutions codify the importance of providing a strong government-funded public education system, require minimum funding levels and establish sophisticated district or bond oversight programs.

Despite widely held views of the importance of public education, there are still challenges in funding and administering education throughout the country. The state of California is seeing record surpluses and financial reserves, and it has been providing significantly more aid to school districts over the past few years after changing its school funding formula. If this is the case, why are schools in the state struggling?

Many districts are confronted with a range of challenges that often reduce dollars available for educational program expansion and funding salary increases and ultimately impact financial reserves and credit quality, including:

- rapidly rising costs, largely from a significant increase in pension funding requirements for the two state-run pension funds;
- demographic shifts resulting from fewer births, which lower enrollment and state operating aid[1];
- growth in charter schools, which also reduces district enrollment and state operating aid[2]
- high costs of living and housing affordability issues, which are driving families out of certain districts; and
- district employee salaries that don't keep up with costs of living.

Our job is to evaluate this set of challenges and ultimately gauge credit quality. We evaluate the district's willingness and ability to use their available tools to solve these issues.

Historically, teacher strikes have been infrequent and usually have resulted from the inability of management and employee unions (often teachers unions) to agree on contract terms, frequently around salary increases. While this hasn't changed, we are seeing a new trend with unions striking over more policy-related issues like class sizes, the numbers of counselors and nurses, school closures, pension funding issues and even the increase in charter schools.

In California specifically, the recent strikes have occurred in districts with declining enrollment and high costs of living adding to these challenges. The timing of these strikes didn't surprise us, because districts and the state are in budget season.

As teachers ultimately need more funding for their initiatives, this presents the most opportune point in the year to influence both the district and the state.

The Impact of Striking Teachers

While we don't take a side in these battles, we analyze the outcomes to understand the impact on the district's credit, of which environmental, social and governance (ESG) is a component, as follows:

Financial Impact: A strike can impact a district in two ways. First, resolution usually includes new contract terms with higher salary and benefit costs from either wage increases and/or increases in staffing. A second impact is on state aid. State aid is often tied to attendance. So, when parents keep kids out of school during a strike—perhaps in solidarity with the teachers or over concerns with education quality when teachers are out of the classroom—it results in less state funding. So, the length of a strike can be important financially. We focus our analysis on the district's ability to afford the increased net costs in the current and future fiscal years. Given that school funding is largely from the state, we view this in the context of the state's fiscal health and commitment to providing additional funding when required.

Community/Enrollment Impact: Declining enrollment can be a financial challenge for districts. Whether general demographics or charter schools are the cause, it can result in funding decreases without commensurate spending decreases. After a strike, we keep a closer eye on enrollment to see if the strike drives more students into charter, religious or private schools, which can further exacerbate general demographic trends.

Management Analysis: Assessing the school management's relationship with its unions is an important component. We carefully watch how management and unions interact and how management deals with the challenges. We want to feel comfortable that management can and will address issues as they occur and maintain a working relationship with its employees.

How Strikes Impact Our Overall Analysis

We then view a particular strike within the context of the larger credit profile of the district:

- We look at the financial position and whether the costs are affordable.
- We determine how much financial flexibility the district has to address its challenges.
- We consider the security structure of the district's bonds to assess the impact of these costs on the ability to service debt.
- We analyze the tax base to understand whether its fixed costs are affordable.
- We look at enrollment trends in context of general demographics as well as academic performance, charter school penetration and costs of living.
- We consider the state's prioritization of funding school aid, its current budget outlook and any policy directives under consideration.
- We dive deep into the pension funds' condition, annual funding needs and pressure points in the future.
- In the case of California in particular, we incorporate the strength that comes from the state's oversight program, which up until now, has helped keep all of its distressed school districts out of insolvency, default and bankruptcy.

Our expertise in this sector has taught us that a strike alone is not a reason for investors to sell the corresponding municipal bond investments. First, strikes usually don't come as a surprise as they are often linked to challenges with the credit that have developed over time. Second, we often continue to hold muni bonds in school districts that have had or could have a strike, because we don't expect the strike to impair the district's ability to service debt.

We might also determine the property tax base can support the debt and that the state's oversight program will provide technical guidance or financial support to help a district avoid insolvency.

While we have highlighted California public schools specifically, these challenges aren't limited to the Golden State. We have seen strikes at districts across the country and in some cases, state-wide strikes.

In any case, our research approach stays the same. We examine credit at the district level to understand its individual challenges, financial tools, management abilities, security structure and long-term liabilities. We look at overall funding pressures, demographic trends and state policy and funding approaches to understand the potential impacts.

As a result of these exhaustive efforts, our municipal bond portfolios are able to invest in school bonds that we think should be able to weather these challenges, and, just as importantly, hopefully avoid others that may be more exposed to downside risks.

The comments, opinions and analyses presented herein are for informational purposes only and should not be considered individual investment advice or recommendations to invest in any security or to adopt any investment strategy. Because market and economic conditions are subject to rapid change, comments, opinions and analyses are rendered as of the date of the posting and may change without notice. The material is not intended as a complete analysis of every material fact regarding any country, region, market, industry, investment or strategy.

This information is intended for US residents only.

To get insights from Franklin Templeton delivered to your inbox, subscribe to the Beyond Bulls & Bears blog.

For timely investing tidbits, follow us on Twitter @FTI_US and on LinkedIn.

What Are the Risks?

All investments involve risks, including possible loss of principal. Because municipal bonds are sensitive to interest-rate movements, a fund's yield and share price will fluctuate with market conditions. Bond prices generally move in the opposite direction of interest rates. Thus, as prices of bonds in a fund adjust to a rise in interest rates, the fund's share price may decline. To the extent a fund focuses its investments in a single state or territory, it is subject to greater risk of adverse economic and regulatory changes in that state or territory than a geographically diversified fund. Changes in the credit rating of a bond, or in the credit rating or financial strength of a bond's issuer, insurer or guarantor, may affect the bond's value. A fund may invest a significant part of its assets in municipal securities that finance similar types of projects, such as utilities, hospitals, higher education and transportation. A change that affects one project would likely affect all similar projects, thereby increasing market risk. Investments in lower-rated bonds include higher risk of default and loss of principal.

For investors subject to the alternative minimum tax, a small portion of municipal bond fund dividends may be taxable. Distributions of capital gains are generally taxable

Federal and state laws and regulations are complex and subject to change, which can materially impact your results. Always consult your own independent financial professional, attorney or tax advisor for advice regarding your specific goals and individual situation.

Past performance does not guarantee future results.

---

1. State operating aid is largely based on average daily attendance, so when enrollment declines so does state aid, assuming per pupil spending doesn't change.

2. Ibid.