WASMER SCHROEDER

A Case for Taxable Municipal Bonds

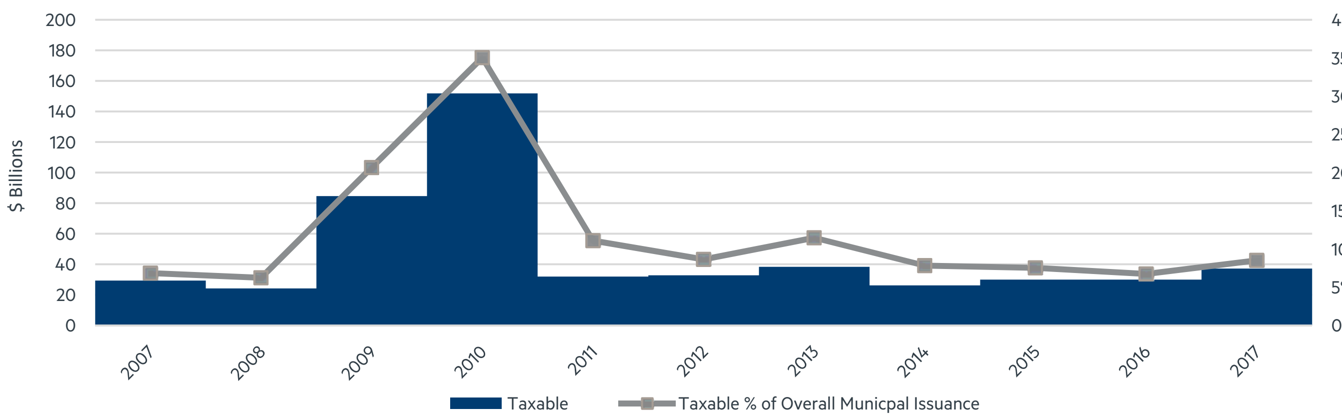
September 2018

History and Evolution of the Market

The development of the taxable municipal market was enabled by the passage of the Federal Tax Reform Act of 1986. The legislation prohibited several types of tax exempt financings, forcing states and municipalities to issue bonds in the taxable market when they could not meet the new requirements Reasons for taxable issuance range from prefunding certain pension obligations to other purposes where, in the opinion of bond counsel, some private purpose entity will substantially benefit from the issuance of debt by the municipality . In addition, municipalities must issue in the taxable market if they are refunding an obligation that has already been refunded once in the tax-exempt market. The credit backing of taxable municipal bonds can be in the form of a General Obligation (GO), or it can be backed by a legally enforceable, dedicated revenue stream, much like their tax-exempt counterparts. From a credit perspective, there is no inherent credit difference between a taxable municipal bond and a tax exempt municipal bond.

As part of the American Recovery and Reinvestment Act of 2009, another class of taxable municipal bonds was created and dubbed the Build America Bonds (BAB) program. To the investor, there is no difference between BABs and non-BAB bonds.

Taxable Municipal Issuance



12/31/2007 – 12/31/2017; Source: The Bond Buyer

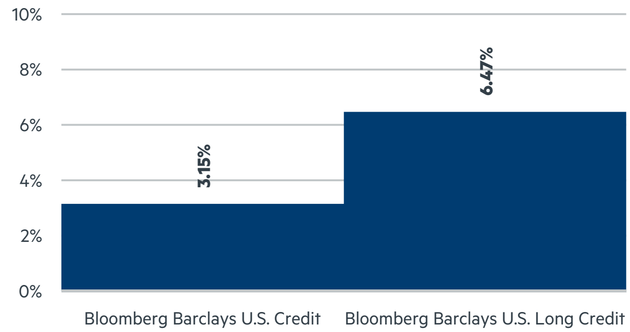
However, the difference was significant to the issuer. While there are several subsets of the BABs program, the basic intent of the legislation was to reimburse municipalities for a substantial portion of the interest expense incurred over the life of the financing. Interest cost reimbursement ranged between 35% and 100%, depending on the purpose of the issuance. During the life of the program, municipalities could make the financial decision on whether to issue in the tax exempt or taxable market based on the net cost to them. The result was an explosion of issuance under the BABs program, which totaled over $200 billion in 2009 and 2010 and accounted for over 30% of all municipal issuance in those years, well above historical measures of between 5% and 10%. Deals tended to be much larger than previously seen in the taxable municipal market. Dealers allocated resources to the asset class and the investor base swelled beyond the traditional players in that market. The major fixed income indices, previously devoid of taxable municipals due to index inclusion criteria, saw their representation increase to a meaningful portion of the Barclays Credit Indices. Despite the program expiring without renewal in December 2010, the BABS program had a major role in improving the liquidity and broadening the investor base of the taxable municipal market, which continues to this day.

One feature of BABs that is not shared by non-BAB taxable municipals is the extraordinary call feature that was written into many of the BABs deals' legal documentation. The language stipulated that if the Federal Government reduced the interest reimbursement to the municipality, the issuer had the right to call their BABs. When the government, as part of the Congressionally mandated sequestration of 2013, reduced the BABs subsidy, most deals became callable, though very few have been called to date. Given the attractiveness of the remaining subsidy and current interest rate environment, it is unlikely we will see any large scale calls in the BABs market.

MARKET COMPOSITION, STRUCTURE AND LIQUIDITY

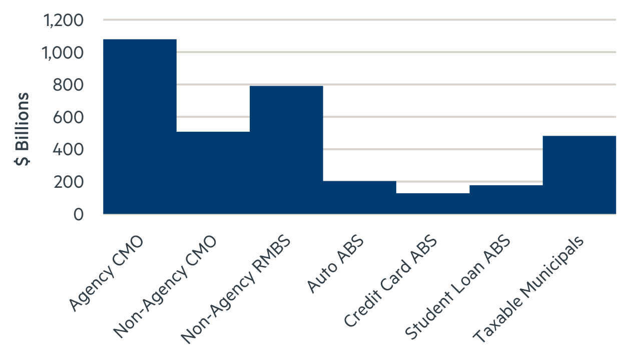
The market, as currently constructed, is quite diverse. Unlike certain areas of the taxable market, the taxable municipal sector is made up of a wide variety of tenors (out to 50 years). The credit quality composition is varied as well, though the vast majority of issuance has been at the top of the investment grade quality spectrum. With the added supply and broadening of the investor base there has been an associated improvement in liquidity. The one defining feature of the taxable municipal market, and to a certain extent the overall municipal market, is that it is fragmented from a dealer perspective. There are literally hundreds of dealers across the country, as well as the large New York-based firms, that make markets in municipal bonds, rewarding investors who have the trading experience and infrastructure to exploit this market structure. Despite this fact,

Taxable Municipal Exposure by Index



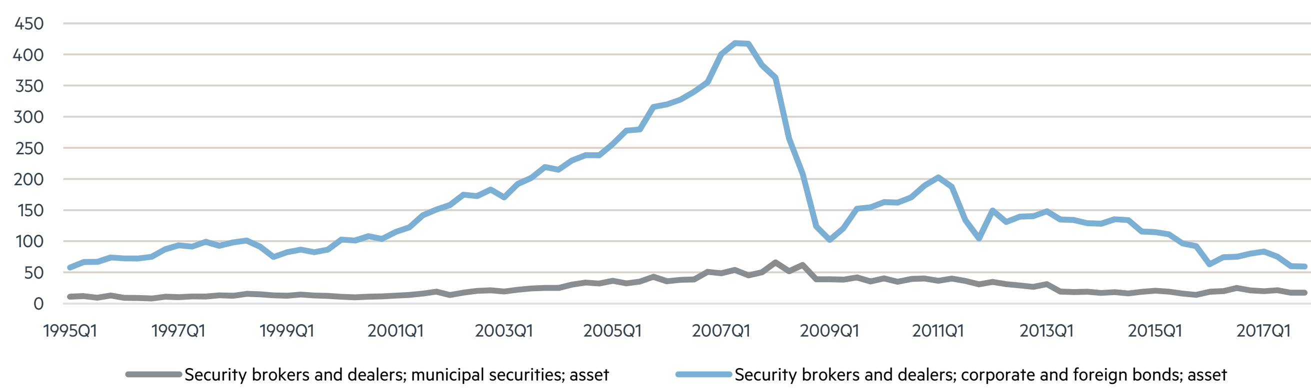
12/31/2017; Source: Bloomberg Barclays

Market Size



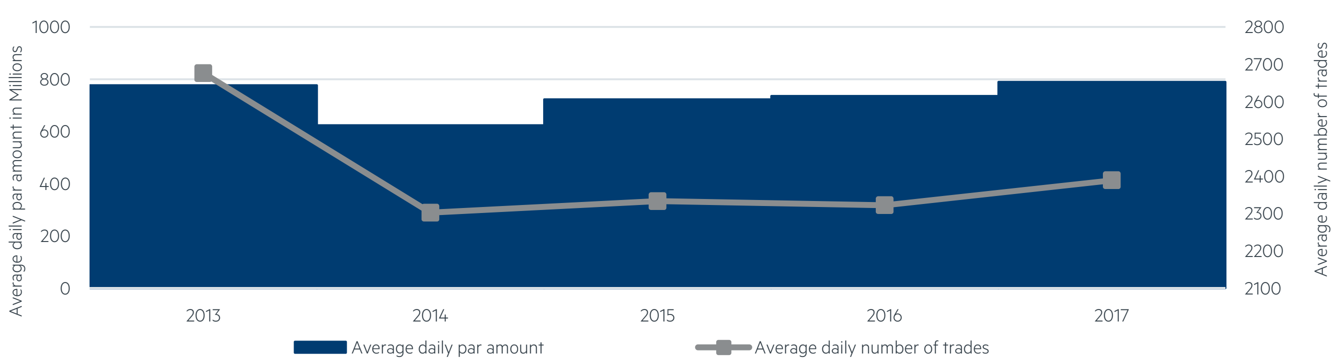
12/31/2017; Source: SIFMA

Broker-Dealer Holdings of Corporate/Foreign Bonds & Municipal Bonds



2017; Source: Federal Reserve Flow of Funds

Taxable municipals Trade Size and Volume



2013 - 2017; Source: MSRB 2017 Factbook

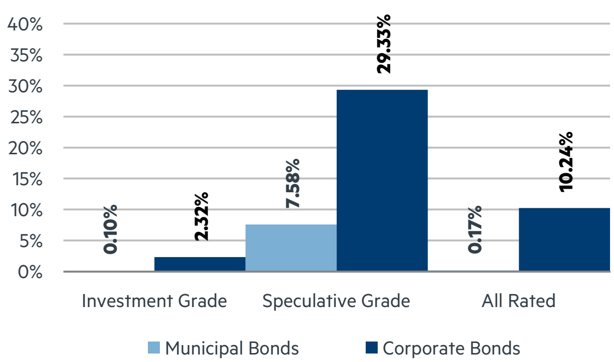
many fixed income investors still perceive the taxable municipal market as being less liquid when compared to the corporate bond market. Since the financial crisis and the passage and implementation of Dodd Frank, those differences have declined markedly. Another factor adding to the general liquidity of the taxable municipal market is its high overall credit quality. The ratings mix of this market is very much skewed to higher rated credits and this adds to the overall liquidity profile. Like corporate bonds, taxable municipal bonds also trade across several electronic platforms.

CREDIT QUALITY

As a point of fact, historical credit quality for municipals is second only to U.S. Governments. In addition, the default probability for municipals, when compared to corporate bonds by ratings category, is significantly lower.

As investors know, past performance may not be indicative of future results, so it is essential that credit quality be measured, analyzed, and monitored, just like any other credit related sector. An independent credit effort identifies a variety of micro and macro trends affecting the market overall, as well as individual issuers. Credit analysis of municipal issuers is very different than other spread sectors. For example, municipalities and state entities are by their very nature perpetual and monopolistic. They must also balance their budgets on an annual basis.

Municipal Market vs. Corporate Market 10 - Year Default Rate Summary



1970 - 2017; Source: Moodys

Unlike the Federal Government, municipalities and state entities do not have the ability to print money to cover deficits. While the budget process can be rancorous and contentious, in the end, compromises are generally made. Credit trends in the municipal market are slow to develop, giving well-informed investors ample opportunities to exit issuers long before problems become acute. This is especially advantageous, as adverse event risk in other spread sectors is often the hardest to predict and is often the most damaging to market value.

VALUATION

Taxable municipals as a sector, while strong from an overall credit perspective, must be compelling when viewed through the prism of relative value for the sector to make sense for investors. Like all spread sectors, taxable municipals move with investor sentiment, the general level of risk aversion, and broad economic fundamentals. An important distinction is that the taxable municipal market is dominated by institutions versus the tax-exempt market, which is dominated by retail investors. There is little impact on the taxable market when retail investors flee the tax-exempt market due to negative headlines by market pundits or specific credit news. There are literally hundreds of mutual funds in the tax exempt market as well as many Exchange Traded Funds (ETFs), where strong inflows and outflows can temporarily distort valuations. Relatively few mutual funds and ETFs are dedicated to taxable municipals, which minimizes fund flow risks. The trading characteristics of the taxable municipal market are beneficial to investors as well as issuers, who have relied on the more sophisticated investor base for funding during periods of market stress.

Taxable municipals are viewed more in comparison to corporate bonds by domestic investors. In these cases, and certainly when viewed from a ratings perspective, taxable municipals often exhibit compelling value against their corporate bond counterparts. There are adjustments that need to be made when evaluating these differences, which include adjusting for deal and issuer size, perceived liquidity, event risk, and credit quality. Many investors have come to the conclusion, as we have, that taxable municipals are not only a valid alternative in the investment grade space, but a sector that offers compelling spreads for the inherent credit quality.

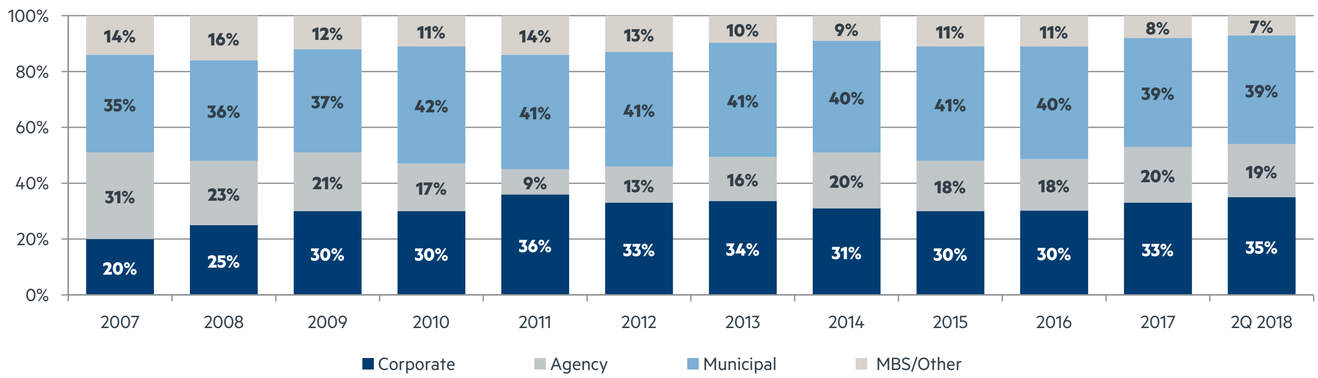
A CASE FOR INCLUSION OF TAXABLE MUNICIPAL BONDS IN FIXED INCOME PORTFOLIO CONSTRUCTION

WS has included taxable municipals in portfolio construction since the inception of the firm's taxable strategies. Our allocation to the sector has always been an important part of our portfolio construction and has been adjusted over time with market environments and relative value assessments.

As longtime participants in the municipal market, we have a competitive advantage which is centered on our ability to analyze municipal credit combined with deep trading experience in the space. Furthermore, as this paper reviews, and the following data supports, there are several quantifiable and unbiased reasons for participating in this market.

Credit Diversification: At their core, taxable municipals are different than many credit sectors. While there is some commonality with regard to credit performance, such as overall strength of the economic environment, the purpose and financial management of these entities is entirely different than those in the for-profit sector.

WS Intermediate Taxable Strategy Historical Sector Allocation



12/31/2017 – 6/30/2018

Correlation: Like nearly all fixed income securities, the driving force behind absolute price performance is the general level of interest rates. However, when analyzing the performance of taxable municipals over an extended time frame, using individual sectors of the corporate bond market for comparative purposes, the evidence shows that taxable municipals exhibit among the highest positive correlation to U.S. Treasuries (at an increased yield advantage) while exhibiting the highest negative correlation to the S&P 500. The findings are summarized in the chart below.

Volatility and Risk/Return Benefits: In the context of other investment grade sectors and U.S. Treasuries, taxable municipal bonds offer a quantitative risk/return benefit when viewed against a backdrop of other fixed income alternatives.

IN CONCLUSION

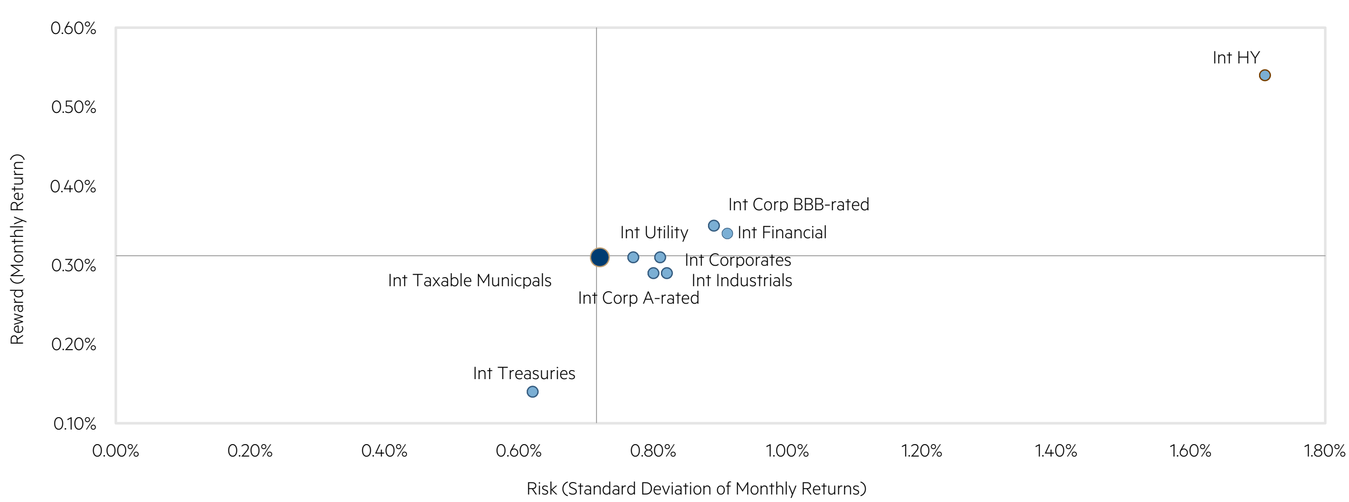
The taxable municipal market is a high credit quality, deep, and liquid sector of the investment grade market. While the investor base is broad, the dealer community is fragmented and regional in nature, rewarding investors who have a commitment to strong independent research and a robust municipal bond trading infrastructure. Taxable municipals offer a valid and compelling value proposition when compared to other areas of the investment grade market and are most often compared to corporate bonds. With the advent of the BABs program, new participants have entered the market and many dealers have built additional infrastructure to accommodate increased trading, which has generally benefitted investors and cemented the long-term existence of this important investment grade sector.

Barclays Capital Indices

	S&P 500	Intermediate Treasuries	Intermediate Taxable Municipal	Intermediate Corporates	Intermediate Industrials	Intermediate Utility	Intermediate Financial	Intermediate High Yield
Correlation to Treasuries	-0.34	1.00	0.85	0.65	0.72	0.85	0.45	-0.06
Correlation to S&P 500	1.00	-0.34	-0.22	0.23	0.15	-0.05	0.35	0.74

6/30/2011 - 12/31/2017; Source: Bloomberg-Barclays;

Risk/Reward Analysis - Bloomberg Barclays Intermediate Indices



6/30/2011 – 12/31/2017 – Based on monthly returns; Source: Bloomberg Barclays

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John Majoros holds the positions of Managing Director, and the Director of Taxable Portfolio Management. He is responsible for the oversight of all taxable strategies at Wasmer Schroeder (WS).

Mr. Majoros earned his B.B.A. in Finance from Cleveland State University and his M.B.A. in Finance from Fordham University. He is a member of the Firm's Executive, Investment, Credit and Portfolio Management committees.

CHRISTOPHER SHEEHAN
Vice President, Senior Portfolio Manager

Christopher Sheehan holds the position of Senior Portfolio Manager and is responsible for co-managing the taxable strategies at Wasmer Schroeder (WS). Mr. Sheehan is accountable for corporate and taxable municipal allocations, security selection and trade execution.

Mr. Sheehan earned his B.A. in Business Administration from Washington & Jefferson College and an MBA from Cleveland State University. He is a member of the Firm's Portfolio Management and Credit Committees

About the Firm: More than 30 years ago, Wasmer Schroeder was founded on the principles of an unwavering commitment to service and a dedication to managing fixed income the right way. From its beginning, the firm has held steadfast in its spirit of collaboration—doing what's right for the advisors, investors, and institutions for whom we manage money. We do right by doing right by them—knowing their businesses, understanding their goals, and consistently finding solutions to meet their needs. As an active fixed income manager with a team of investment professionals across tax exempt and taxable strategies, we are dependable, collaborative, and insightful in our approach. Backed by research and emboldened by technology, our hands-on team is a true partner to the advisors, investors, and institutions who give us their trust.