WASMER SCHROEDER

The Benefits of Applied Credit Within Municipal Bond Portfolios

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Know Your Risk Exposures

The concept of applied credit within a tax exempt separately managed account centers on three key themes that Wasmer Schroeder (WS) considers to be core tenets of the municipal bond market: strong, stable, credit quality; low default rates; and inefficiencies in the pricing of municipal risk premiums. Effective credit research, in the form of intensive up-front underwriting efforts and consistent, ongoing issuer surveillance activity, is the key ingredient required to capitalize on these themes for investors seeking to take advantage of credit opportunities within a managed portfolio. For those reasons, which are expanded upon below, WS believes that an allocation to single-A and triple-B rated credits should be a core component of how municipal bond investors build out the yield profile of their portfolios.

Historical default rates and credit rating volatility suggest that municipals are underrated from a quality perspective when compared with corporate bonds. Municipal default rates, spanning all measured periods of time, have consistently demonstrated materially lower risks of principal loss for municipal bond investors when compared with default rates in corporate bonds. In fact, according to Moody's, the default rates on single-A rated corporate bonds are more than 25 times higher than single-A rated municipals.

5-Yr Default Rates 1970-2017	Muni Default Rate	Corporate Default Rate
All Rated Securities	0.09%	6.70%
Investment Grade	0.04%	0.91%
A Rated	0.03%	0.74%
BBB Rated	0.49%	1.55%
Speculative Grade	5.13%	18.77%

1970 -2017; Source: Moody's Investor Services, U.S. Municipal Bond Defaults and Recoveries

Given these credit characteristics, WS believes that an over allocation to triple A rated and double-A rated bonds presents a specific type of risk to clients in the form of opportunity cost that is often left unaddressed when establishing a municipal bond portfolio. Credit spreads on Single A-rated and triple B-rated municipal bonds can materially enhance the income-generating capabilities of a portfolio. By acknowledging the relative rating stability and extremely low instances of distress and default in the municipal bond market, investors that can withstand incrementally higher volatility within their portfolios are doing themselves a disservice by not capitalizing on the credit opportunities that many single-A rated and triple-B rated bonds municipal bonds provide. Over time, this opportunity cost grows larger, as the lack of spread income within the portfolio compounds in the form of lost cash flow and lower reinvestment returns.

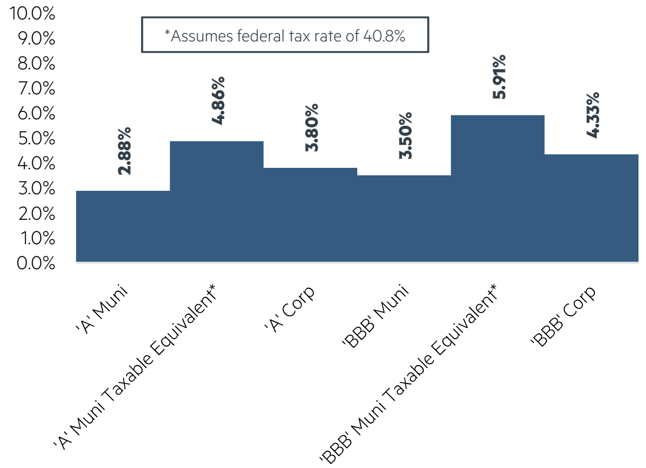
Captured risk premiums (i.e. "credit spreads") in the municipal bond market exhibit low correlation to and are less volatile than corporate bond spreads. Over the past five years, 10-year, single A-rated municipal bond spreads and 10-year, single A-rated corporate bond spreads produced a correlation of 0.3 and an r-squared of 9% --both of which show a weak relationship between the two security types. The level of independence exhibited by these measures indicates that it would be highly unlikely to see municipal bond spreads widen simply because of spillover activity from the corporate sector.

Additionally, municipal bond spreads have been far less volatile than corporate spreads, during this period. The standard deviation of 10-year, single A-rated municipal spreads was almost 40% lower than that of 10-year, single A-rated corporate spreads, showing that municipal spreads have tended to move within a much tighter range than their corporate counterparts.

Tax status also factors into the equation, as seen in the table to the left--municipal bonds are tax exempt and corporate bonds are taxable, enhancing the value proposition of municipals even further when they are evaluated on a taxable equivalent basis.

WS's approach to credit research entails a "zero-default rate" underwriting threshold, and only issuers that pass our credit department's rigorous underwriting process are approved for investment. *Know your risk exposures.* That philosophy drives our approach to credit investing. When evaluating opportunities for purchase, WS looks at an issuer's core credit quality characteristics, financial trend analysis, sector relative value metrics, strength of primary market access, and secondary market liquidity profiles. Our approach is predicated upon understanding the risk-adjusted characteristics of the municipal market, and we generally avoid the trouble areas of the market where history suggests that credit risk is most acutely concentrated, such as small non-rated credits and tobacco bonds.

Yield-to-Worst Comparisons



6/30/2018; Source: Bloomberg Barclays

For investors seeking to maximize tax exempt income, the application of credit within a municipal SMA should focus on hitting for average, not hitting home runs. Deploying a thoughtful, measured approach to credit within a municipal bond portfolio can be a highly effective way to enhance yield without materially altering the investor's risk profile. In a low interest rate environment, the compounding effects of credit spreads and income reinvestment over time can result in notable performance benefits for patient and informed investors.

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Jason Diefenthaler is the Director of Tax Exempt Portfolio Management and is responsible for the oversight of all tax exempt strategies, as well as the Wasmer Schroeder High Yield Municipal Fund (WSHYX) at Wasmer Schroeder (WS).

Mr. Diefenthaler earned his B.S. in Finance from Florida State University. He is a member of the Firm's Executive, Portfolio Management, Credit, Investment, Risk, and Compliance 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.