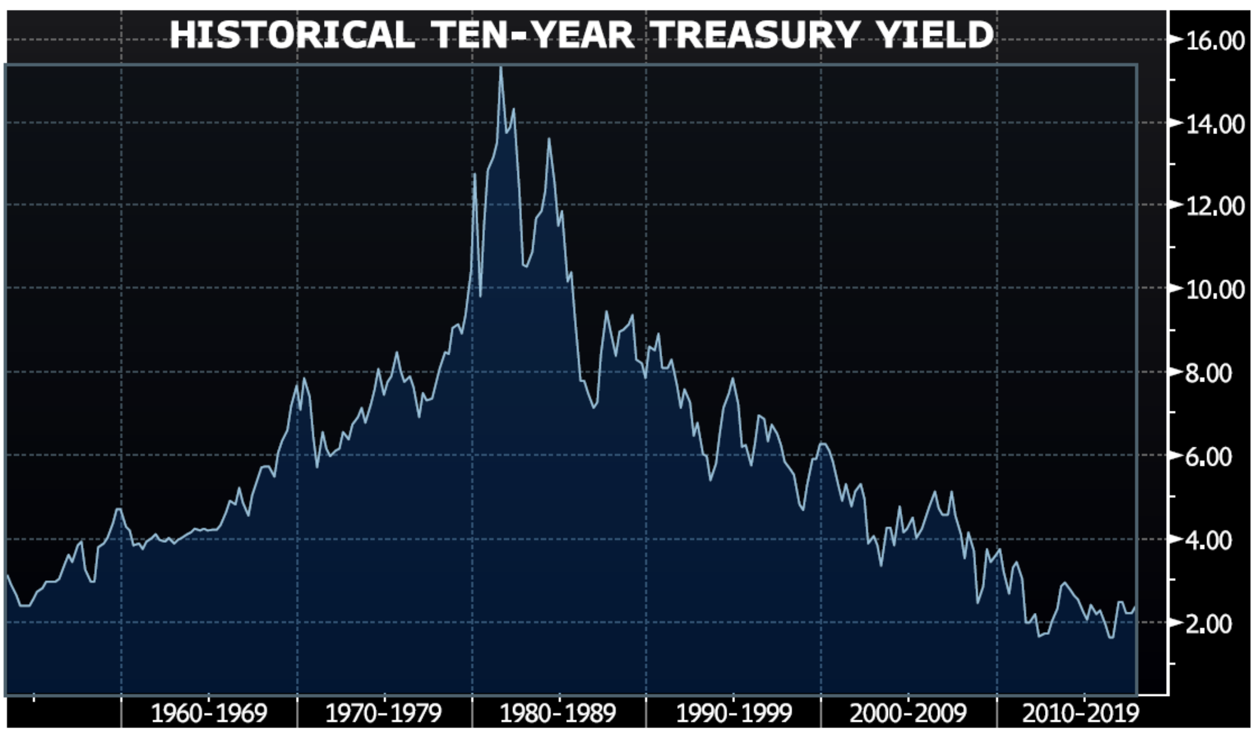
Fixed Income Commentary
Winter 2018

Interest rates marched higher this quarter, but consistent with the general trend for most of 2017, short-term bond rates increased by more than long-term rates. The yield on Treasuries with two years until maturity started the year at 1.2% and ended at 1.9%. In contrast, the yield on ten-year Treasuries has fallen from 2.5% to 2.4%. These movements have flattened the yield differential between the ten-year and two-year Treasuries from 1.3% at the beginning of the year to 0.5% at year-end – the narrowest the spread has been since mid-2007, and down from a peak of 2.6% in early 2014.

The flattened differential between rates on long-term and short-term bonds is largely driven by the Federal Reserve's ("Fed") persistence in ratcheting the federal funds rate higher in a low inflationary environment. The Fed is pursuing this policy because it believes the tight labor market, with unemployment currently at 4.1%, will eventually cause inflation to overshoot their stated 2% target. While the Fed can significantly influence the rate on short-term bonds, market forces– including expected inflation, expected economic growth rates, and supply and demand imbalances – determine rates for longer-term bonds. Stagnant long-term rates mean market participants either don't believe or are ignoring the inflation concern. In such an environment, we see value in the short-end of the yield curve and are comfortable maintaining our conservative position with a higher concentration of maturities within the next four years. While we're not attempting to forecast the interest rate path over the next few months, we're happy to pare back interest rate risk to our clients when it doesn't cost us much to do so and absolute interest rate levels remain very low from a historical perspective.



The sweeping tax reform passed in December introduced some structural changes to the fixed income market, with municipalities feeling the most direct impact. First, the new bill eliminates municipalities' ability to pre-refund issuances. Municipalities historically had the ability to effectively retire their old debt in advance when conditions were favorable by issuing new bonds at lower rates, and using the proceeds to purchase Treasury bonds that would then be used to pay the interest and principal payments to holders of the original bonds. Pre-refunding was attractive to municipalities and investors alike. Pre-refunded muni bonds offered a federally tax-exempt income stream that was effectively backed by the US government. Without new supply of pre-refunded debt, clients invested in our municipal bond strategy will notice a diminished allocation to this security type going forward.

Second, the alternative minimum tax ("AMT") no longer applies to families earning less than $1 million of income, which should boost the price of qualified private activity bonds ("PABs"). PABs are municipal bonds issued to finance projects that benefit the general public, but might also enrich private businesses. Like other municipal bonds, interest on the bonds is federally tax-exempt; however, the interest becomes taxable if an investor is subject to the AMT. Since many institutions and mutual funds avoided such bonds to avoid the possibility of the interest on a portion of their portfolios becoming taxable, PABs offered incremental yield over traditional municipal bonds as long as an investor was fairly certain he or she would not be subject to the AMT. Previously, taxpayers could be subject to AMT with as little as $200,000 in income, but with the increased exemption amount, the pool of PAB buyers should increase dramatically – driving prices up and yields down. We will continue to search for value in the PAB space, but the days of "free" incremental yield to non-AMT clients could be a thing of the past.

Lastly, the tax bill caps the federal tax deductibility of state and local taxes ("SALT") at $10,000. Without the deducibility, there's a double taxation on income at both the federal and state level. This change hurts high-income citizens of high-tax states the most – especially residents of New York, New Jersey, and California. While we don't foresee an imminent mass migration of citizens from high-tax states to low-tax states, the limited deduction meaningfully increases the cost of living in high-tax states, and there will be pressure for these states to cut costs and spending to lower taxes. We do not believe the change causes any credit concerns for our eight-year maximum maturity municipal bond ladders, but we'll follow the long-term effects of the tax change closely.

The tax reform's impact on other areas of the bond market were less direct, but still meaningful. The changes were positive for our clients' corporate bond portfolios. The top corporate tax rate was slashed from 35% to 21%, boosting after-tax cash flows of most companies. With less cash being siphoned for tax payments, there's more available for interest payments and debt reduction, which increases the creditworthiness of corporate borrowers.

For our clients' mortgage bond portfolios, the tax bill was likely a net positive. Personal income tax rates were also decreased, which, similar to the corporate outcome, enhances the creditworthiness of the underlying borrowers by increasing homeowners' capacity to cover mortgage payments. On the other hand, the new tax bill limits the federal tax deductibility of home mortgage interest and property tax expenses through an increased standard deduction, elimination of supplementary itemized deductions, and the SALT cap. By decreasing the deductibility of these home expenses, residential ownership becomes relatively more expensive compared to renting, which should be a negative for home prices. Our clients' portfolios are focused on mortgages originated before 2005, so any pullback in prices related to this should have nominal effects on borrowers' home equity, considering that over ten years of mortgage payments and home appreciation are already factored in.

Closed-End Fund Commentary

As first discussed in the Winter 2016 newsletter, we initiated a position in closed-end funds in December 2015 to exploit what we believed to be a market dislocation. Even though we avoided, and even discouraged, closed-end funds in the past, we thought the market for closed-end funds that invest in high-yield debt presented a unique opportunity set that stacked the odds of successful returns in our clients' favor.

For background, closed-end funds have a fixed amount of capital and a fixed number of shares that trade on an exchange in the same fashion as common stocks. Unlike typical open-end mutual funds and ETFs, their market prices can vary – sometimes significantly so – from their net asset value ("NAV"). Because of their fixed capital base, these funds also typically employ leverage, although the amount of leverage varies among individual funds depending on the underlying assets owned by the fund and the discretion of the manager.

While many closed-end funds regularly trade at some discount to their NAV, we observed unusually large discounts for closed-end funds that invest in high-yield debt. The dislocation seemed to stem from a combination of two factors: 1) the perception that rising short-term interest rates would increase borrowing costs for leveraged funds, and 2) expanding credit spreads[1] for fixed income instruments caused a decline in the net asset value of many funds. Because of these factors, investors in closed-end funds, who were traditionally individuals attracted solely by the leverage-enhanced distribution rates (sometimes called "yields") offered by these funds, began abandoning the space. This sustained selling pressure expanded the difference between market price and NAV to levels not seen since shortly after the financial crisis of 2008.

In keeping with our investment philosophy, our decision to buy was made when everyone else seemed to be selling. Despite our prior aversion to the asset class, we ultimately determined that the combination of closed-end funds trading at discounts to NAV approaching 15% in many cases, and high yield bonds trading on the cheap end of historical norms, had stacked the odds in our clients' favor. We selected funds that were invested in high yield corporate bonds, bank loans[2], and asset-backed securities that we felt offered the best risk-return profile for clients. We also used a diversified portfolio approach with the goal of minimizing the risk of any single fund performing substantially worse than the asset class as a whole.

We believe our investment thesis played out during 2016, and continued to do so in 2017. Credit spreads narrowed, and corporate defaults remained low. Both factors enhanced returns by increasing bond prices, pushing fund NAVs higher. Throughout the year, we exited many individual fund positions as their market price approached their respective net asset values. So far, we've successfully exited roughly half the closed-end fund positions that we purchased for clients two years ago. We

[1] Credit spreads are the difference in yield between bonds of differing credit quality. As credit spreads expand, bond yields increase and high yield bond prices decrease.

[2] Bank loans, sometimes referred to as leveraged loans, are typically made to businesses that are too small to attract enough demand to float a typical bond issue. In terms of risk, these securities are similar to high yield bonds and they typically have floating-rate coupons.

believe the remaining positions in client accounts still offer relatively attractive risk-return profiles, and we continue to be patient in our sale decisions by waiting for fund prices to reach more reasonable discounts to NAVs.

Going forward, we're cautious about the state of the high yield bond market. Yield-starved investors have pushed high yield bonds to historically rich levels, which impairs future returns and increases downside scenarios in a broad market selloff. Prolonged periods of high demand can deteriorate underwriting standards and impair bond quality. On the positive side, high yield credit metrics are still healthy and the US economy is healthy by most measures. We've conservatively structured our clients' closed-end fund portfolios in an attempt to neutralize these market factors and weather volatility in the high yield bond market. In the meantime, we believe our clients should be content with receiving an attractive income stream while we await better valuations.

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