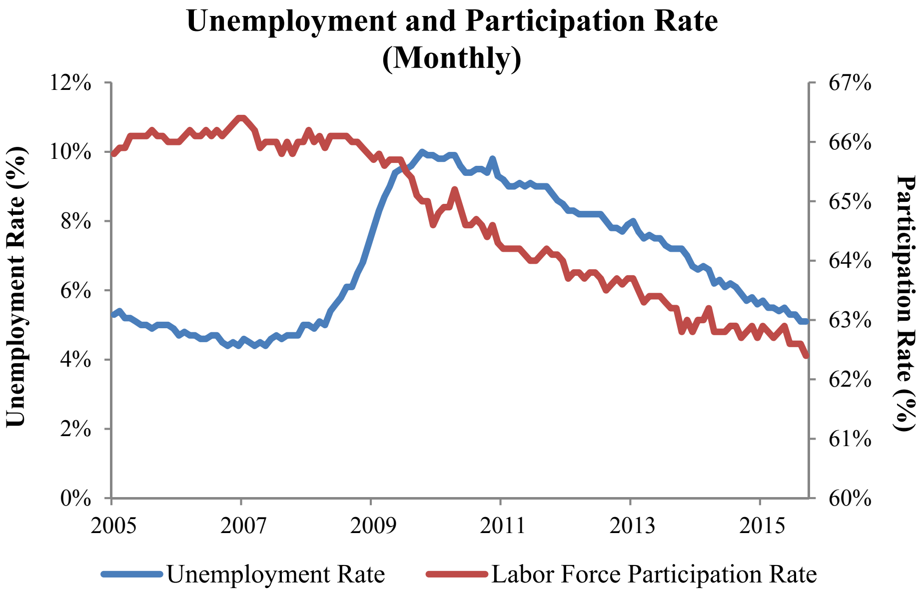
Quarterly Market Review **Fall 2015**

Market Update: Municipal bond yields decreased during the third quarter with AAA 5-year, 10-year, and 20-year yields falling 10, 25, and 21 basis points, respectively. In mid-September, the Federal Reserve reaffirmed its view to maintain the target range for the federal funds rate of 0.00% - 0.25%. As a result of the Fed announcement, the futures market is pricing in a fifty-percent chance that the first rate hike will not occur until March of next year.

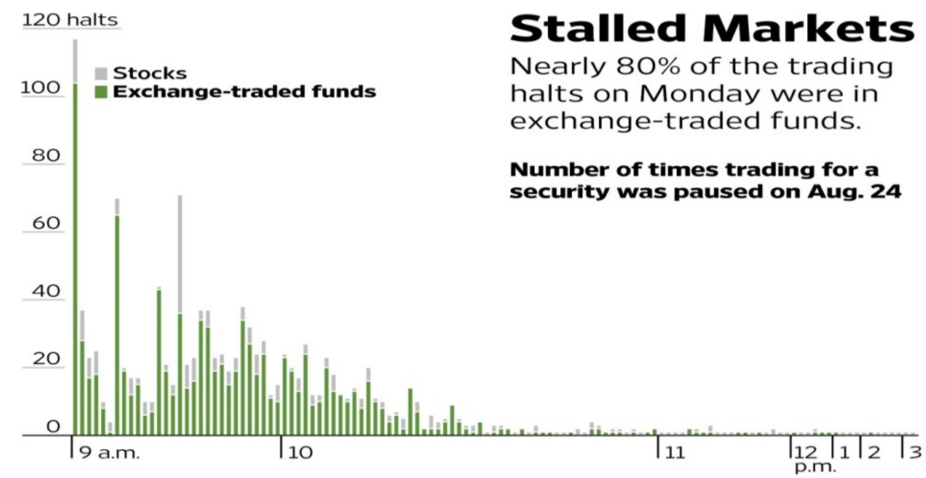
Overall, investors looked to reduce risk within their portfolios, as uncertainty about the global economy caused concern in the marketplace. Weak economic numbers out of China, lower corporate profits, and the Fed's September announcement reaffirming its target range for the federal funds rate all caused market participants to sell equities and look to safe havens for shelter. Corporate spreads widened and the cost of insurance increased significantly, especially in the high yield market. U.S. economic numbers did not buoy investors' fears as September payroll data came in weaker than expected and August was revised lower than originally measured.



Sources: US. Bureau of Labor Statistics, *Civilian Unemployment Rate* [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/UNRATE/, October 2, 2015.

US. Bureau of Labor Statistics, *Civilian Labor Force Participation Rate* [CIVPART], retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/CIVPART/, October 2, 2015.

Liquidity Illusion: The Dow Jones Industrial Average opened drastically lower, briefly falling by more than 1,000 points, on Monday, August 24, 2015. Throughout the August 24th trading session, there were over 1,300 trading halts in various security types, most of which occurred in ETFs. Many of these ETFs actually declined more than the underlying holdings they track. The Vanguard Consumer Staples ETF fell 32% in early trading, for example, while its underlying holdings only fell 9%. According to a Wall Street Journal article, one investor put it best by saying that ETFs "weren't as liquid as they should have been."



Sources: Hope, Bradley, and Dan Strumpf. "Stock Halts Added to Monday's Market Chaos." WSJ. N.p., 27 Aug. 2015. Web. 30 Sept. 2015. <http://www.wsj.com/articles/stock-halts-added-to-mondays-market-chaos-1440717753>.

Hope, Bradley, Saumya Vaishampayan, and Corrie Driebusch. "Stock-Market Tumult Exposes Flaws in Modern Markets." *WSJ.* N.p., 25 Aug. 2015. Web. Summer 2015. <http://www.wsj.com/articles/stock-market-tumult-exposes-flaws-in-modern-markets-1440547138>.

Our take: We believe that the creation and growth of ETFs is a good thing for the industry, as it gives small retail investors access to more investment options. The belief, however, that these structures have superior liquidity (i.e. the "Liquidity Illusion") versus other investment structures, such as holding individual bonds, is misleading and incorrect. The market sell-off on August 24th is a prime example. We believe clients seeking exposure to the municipal market benefit from holding a portfolio of individual municipal bonds via separately managed account (SMA) structures. This framework allows investors to own municipal bonds and continue to hold them during market selloffs, without being subject to other investors sometimes irrational redemption behavior. A portfolio of individual municipal bonds will prove less volatile on days like August 24th.

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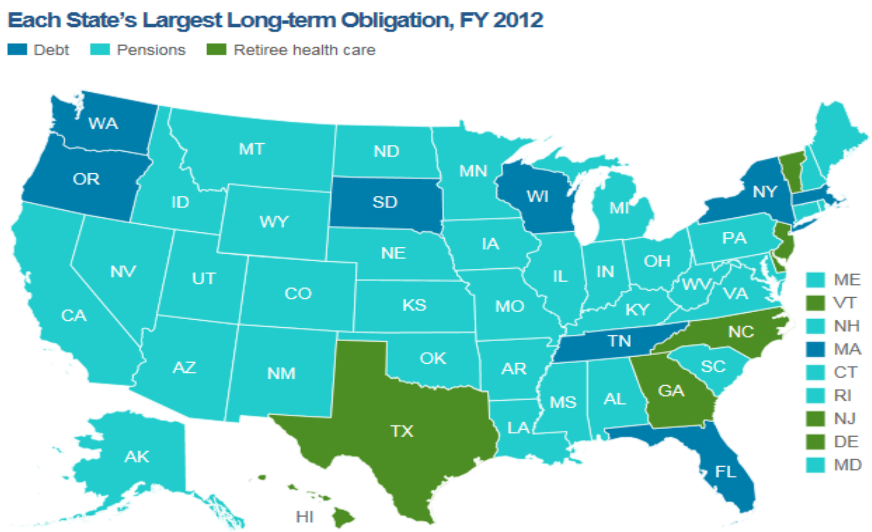
"Illinois Effect": The State of Illinois has many financial problems to overcome. Increasing expenses, growing underfunded pension liabilities, and lower revenues as a percentage of overall expenses have created an unsustainable financial path for the state. The state's fiscal problems result in all municipalities within the state paying a price, even if they are perfectly sound credits. We call this the "Illinois Effect" and the price paid comes in the way of higher yields on debt. The financial problems at the state level mean investors demand higher compensation when investing in municipalities within the state.

Our take: We would agree that the State of Illinois is currently operating on an unsustainable path. We have been opportunistically and selectively trimming our Illinois exposure in client portfolios for several years. That said, there are many opportunities for our clients to earn extra yield, while investing in sound credits within the state. These credits are forced to pay a penalty because of the "Illinois Effect." Sometimes this penalty can be a substantial basis point spread above market averages. It is these opportunities that provide benefit to our clients and are the ones we seek. We have developed an expertise in analyzing municipal bond credits over the past 30 years. We rely on our resources and experience performing the necessary in-depth credit research in order to uncover these values for our clients' portfolios.



Sources: The PEW Charitable Trusts

Pre-refunded Issues: We felt we would take a deeper dive into pre-refunded issues, following up on last quarter's update on the increase in municipal supply. We have seen several pre-refundings over the past two years in the municipal market. An issue becomes pre-refunded when an issuer issues new bonds, at lower rates, to pay off the existing bonds. The proceeds from this bond issue are placed in an escrow account, typically invested in US government securities. These funds are used to pay off principal and interest payments on the pre-refunded bonds. This type of structure benefits both the issuer and the investor. The issuer is able to access the debt market and borrow at lower rates, decreasing its costs and therefore the costs to its taxpayers. The investor continues to earn the same tax-exempt yield where they originally bought the issue and now holds a bond that is backed by US government securities, giving it an automatic credit boost.

Bond Description	Pre-refunded Date	Previous Rating	Tax-exempt YTM* Maturity @ Date of Purchase	Spread to Comparable Treasury (as of 9/30/15)
Texas MUD 4.350% Original Maturity: 09/01/2016 Purchase Date: 10/03/2007	5/1/2016	A3/AA	4.35%	**+414 bps**
Iowa School Dist 4.250% Original Maturity: 07/01/2023 Purchase Date: 07/28/2011	7/1/2017	NR/A	4.43%	**+386 bps**
Massachusetts Electric Rev 4.000% Original Maturity: 01/15/2019 Purchase Date: 03/13/2013	1/15/2018	NR/AA+	1.30%	**+56 bps**

***YTM = Yield To Maturity**

Our take: Above we have provided, for additional perspective, a table of bonds held in our clients' portfolios that have become pre-refunded since they were purchased. We have provided the spread to the comparable taxable Treasury for each issue. The above issues received a credit boost, as they are secured by U.S. government securities AND continue to earn interest income free from federal income taxes. These are just a few examples of areas we look to find opportunities and add value to our clients' portfolios.

Bond Basics: The Benefits of Specialty State Issues

Fall 2015

There are certain states within the U.S. that offer residents investing in in-state municipal bonds the benefit of double-tax exemption on interest - or exemption from both Federal **AND** State income taxes. We refer to those states offering double-tax exemption and whose top state income tax bracket is 5% or greater as "Specialty States." A list of the specialty states and territories throughout the U.S. within the criteria above is provided below (excluding Puerto Rico, the Virgin Islands, and Guam):

Alabama, Arkansas, California, Colorado, Connecticut, Delaware, Georgia, Idaho, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, New York, North Carolina, Ohio, Oklahoma, Oregon, Rhode Island, Utah, Vermont, Virginia, Washington D.C., and West Virginia

Many of these issues trade "rich" (i.e. at lower yields) compared to non-specialty state credits, as demand for them is higher due to the double-exemption. Given the fact that they normally trade with lower yields versus other comparable issues, various clients have asked us whether these issues are worth investing in for clients residing within those particular states. We did an analysis, due to these inquiries, of actual purchases made in various client portfolios of specialty state residents.

Our results show there is a definite benefit for specialty state clients investing in double-tax exempt, in-state bonds. This benefit increases for longer maturities, and is particularly notable for callable securities when looking at the yield-to-call. Even for clients in lower income tax specialty states, such as Ohio, a taxable-equivalent yield benefit is available from in-state municipal holdings. We have provided some examples of the benefits double-tax exemption offers in-state residents when investing in municipal bonds.

Although in-state issues offer great value to specialty state clients, we understand other managers automatically allocate between 75-90% of assets for investors that reside in high income tax states to in-state issues. While on the face this may look better to some, it does not necessarily translate into better value investing. We believe in state and sector diversification and therefore, unless otherwise directed by the client or client advisor, we avoid allocations of 75% - 90% to any one state. We typically have a weighting of anywhere from 35% - 65% in specialty state issuers for in-state residents.

Study 1 (OH resident)

OH Resident; 25% Fed. Tax Bracket; 3.40% (tiered est.) OH Tax Bracket

Bond Description	Tax-Exempt Yield at Purchase	Taxable-Equivalent Yield (Fed tax exempt)	Taxable-Equivalent Yield (Double-tax exempt)	U.S. Treasury Rate @ Date of Purchase
OH Water Rev 2.125%	2.13%	2.84%	2.97%	1.85% (10 Year)
Maturing 12/01/2024		*+101 bps*	*+112 bps*	
Aa2/NR		**Difference**	**+11 bps**	
Purchased: 3/24/2015				

Study 2 (CA resident)

CA Resident; 25% Fed. Tax Bracket; 9.30% (tiered est.) CA Tax Bracket

Bond Description	Tax-Exempt Yield at Purchase	Taxable-Equivalent Yield (Fed tax exempt)	Taxable-Equivalent Yield (Double-tax exempt)	U.S. Treasury Rate @ Date of Purchase
CA Sch Dist. 4.00%	1.20% (call) 1.719% (maturity)	1.60% (call) 2.29% (maturity)	1.83% (call) 2.62% (maturity)	0.99% (3-Year) 1.52% (5-Year)
Maturing 08/01/20 Callable 08/01/19		*+77 bps (maturity)*	*+110 bps (maturity)*	
Aa3/AA		**Difference**	**+33 bps**	
Purchased: 8/11/2015				

Study 3 (NY resident)

NY Resident; 25% Fed. Tax Bracket; 6.65% (tiered est.) NY Tax Bracket

Bond Description	Tax-Exempt Yield at Purchase	Taxable-Equivalent Yield (Fed tax exempt)	Taxable-Equivalent Yield (Double-tax exempt)	U.S. Treasury Rate @ Date of Purchase
NY UTGO 2.500%	2.00%	2.67%	2.93%	1.52% (5-Year)
Maturing 06/15/2021		*+115 bps*	*+141 bps*	
NR/AA		**Difference**	**+26 bps**	
Purchased: 5/28/15				

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