

Quarterly Market Review

Winter 2015

Market Update: As many market participants anticipated, on Wednesday, December 16th the Federal Reserve announced its first rate hike since 2006 increasing the fed funds rate to a range of 0.25% - 0.50%. Despite the news, municipal bond yields decreased during the fourth quarter with AAA 5-year, 10-year, and 20-year yields falling 2, 11, and 25 basis points, respectively. According to Bloomberg, the market is not projecting a rate hike during the Fed’s January meeting (0% probability – see below).

Municipal* bonds outperformed all other fixed income sectors, returning 3.25% for the year. They outperformed Treasuries* (0.85%), investment grade corporates* (-0.80%), and high-yield* debt (-3.49%). Municipals also performed better than many of their equity counterparts, outperforming the S&P 500 Index (-0.73%) and the Dow Jones Industrial Average (-2.23%).

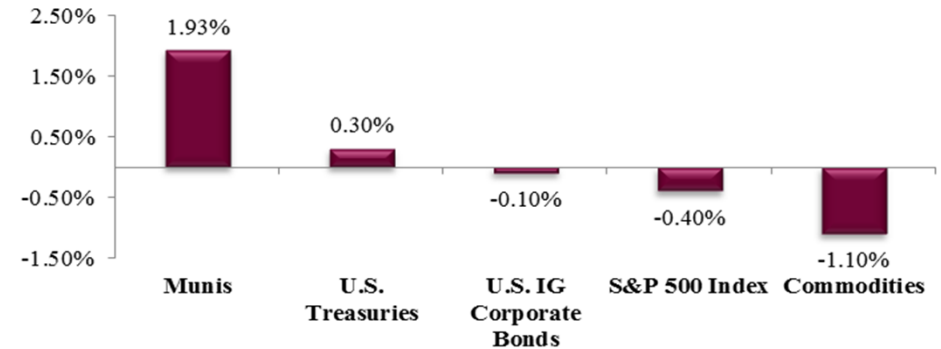
*Source: Municipals – S&P Municipal Bond AMT Free Index; Treasuries – Bloomberg US Treasury Bond Index; Corporates – Bloomberg US Corporate Bond Index; High Yield – Bloomberg US High Yield Corporate Bond Index

Federal Funds Rate Hike/Cut Probabilities (as of 12/31/15)

| United States | | Instrument | | Futures: Fed Funds | | FED Effective Rate 0.36 | | | | |
|-------------------------------|--------------|-------------------------------|-----------------------|--------------------|-------------------------|-------------------------|--------|----------|----------|--|
| 1) Overview | | 2) Future Implied Probability | | | | 3) Add/Rem | | | | |
| Current Implied Probabilities | | | | | | | | | | |
| Dates | Meeting | Calculation | Calculated 12/31/2015 | | Based on rate 0.25-0.50 | | | | | |
| Meeting | Prob Of Hike | Prob of Cut | 0-0.25 | 0.25-0.5 | 0.5-0.75 | 0.75-1 | 1-1.25 | 1.25-1.5 | 1.5-1.75 | |
| 01/27/2016 | 0.0% | 6.0% | 6.0% | 94.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | |
| 03/16/2016 | 50.8% | 2.8% | 2.8% | 46.5% | 50.8% | 0.0% | 0.0% | 0.0% | 0.0% | |
| 04/27/2016 | 56.3% | 2.4% | 2.4% | 41.2% | 50.2% | 6.1% | 0.0% | 0.0% | 0.0% | |
| 06/15/2016 | 74.5% | 1.4% | 1.4% | 24.2% | 46.3% | 25.5% | 2.7% | 0.0% | 0.0% | |
| 07/27/2016 | 78.8% | 1.1% | 1.1% | 20.1% | 42.3% | 29.3% | 6.8% | 0.5% | 0.0% | |
| 09/21/2016 | 86.5% | 0.7% | 0.7% | 12.9% | 33.8% | 34.2% | 15.3% | 2.9% | 0.2% | |
| 11/02/2016 | 89.4% | 0.5% | 0.5% | 10.1% | 29.1% | 34.1% | 19.6% | 5.7% | 0.8% | |
| 12/14/2016 | 93.3% | 0.3% | 0.3% | 6.3% | 21.6% | 32.1% | 25.3% | 11.2% | 2.7% | |
| 02/01/2017 | 95.0% | 0.2% | 0.2% | 4.8% | 17.6% | 29.4% | 27.1% | 14.9% | 4.9% | |

Source: Bloomberg. Accessed: 12/31/15.

Risk - Adjusted Returns



Sources: Chappatta, Brian. "Munis' Risk-Adjusted Returns Beat Other Assets in Turbulent 2015." *Bloomberg Briefs*. Bloomberg, 04 Jan. 2016. Web. 04 Jan. 2016. <http://newsletters.briefs.blpprofessional.com/document/xQTkFQqXyJwaY27Gizptg--_4szljx3apuiz6j8sco/credit-close-up>.

Munis Display Best Risk-Adjusted Returns: On a total and risk-adjusted return basis, the municipal bond market outperformed many of its counterparts during calendar year 2015. Risk-adjusted returns for the municipal market during 2015 were 1.93%. This beat the risk-adjusted returns of Treasuries (0.30%), investment grade corporates (0.10%), the S&P 500 Index (-0.40%), and Commodities (-1.1%). The municipal market has held the top spot on a risk-adjusted basis over four of the past five years.

Our take: In our Spring 2015 Market Review we completed a similar study detailing the relationship between municipal rates vs. Treasury rates. In that study, we found over time tax-exempt municipal rates have experienced lower volatility than Treasuries. It is important for investors to understand what risks are being taken and if they are getting properly compensated for those risks. The historical relative safety of the municipal sector, coupled with our rigorous credit analysis process, allows us to provide our clients with the capital preservation they desire, while capturing attractive yield opportunities within the market. The consistent and attractive risk-adjusted returns generated in the municipal market underscores the notion that municipals deserve an allocation in every investor’s portfolio.

See Bernardi Spring 2015 Market Review Here:

<http://www.bernardisecurities.com/content/quarterly-market-review-spring-2015>

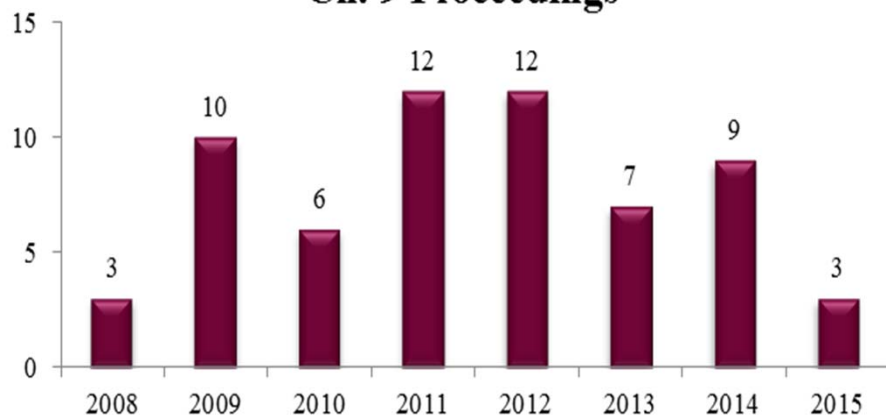
Quarterly Market Review

Winter 2015

Bankruptcy Filings Fall: This past year the municipal bond market saw the lowest caseload of Chapter 9 bankruptcies since 2008. During the year, only three issuers filed for Chapter 9 bankruptcy. This compares with nine Chapter 9 cases in 2014. All three cases were relatively small and included a hospital and a special tax development district. The largest case, Hillview, Kentucky, was brought on after the city lost a lawsuit with Truck America Training over a land dispute. The cities liabilities are between \$50 to \$100 million versus assets of only \$1 to \$10 million.

Our take: The reduction of bankruptcies year-over-year shows continuing improvement of credit strength within the municipal sector. Despite the drop in Chapter 9 filings, sound municipal credit analysis is still essential for the investment process. All three Chapter 9 cases this year are prime examples of the benefits of a sound analysis process and framework; none of the credits that defaulted were on Bernardi's approved list of credits due to their weak purpose, structure, or credit quality.

Ch. 9 Proceedings



Sources: Rozens, Aleksandrs. "2015 Sees Lowest Chapter 9 Caseload Since 2008." *Bloomberg Briefs*. Bloomberg, 22 Dec. 2015. Web. 22 Dec. 2015.
<http://newsletters.briefs.blpprofessional.com/document/xQTkFQqXyJwaY27Gzizptg--4sz1jelglp6z81lo7q/insight-bankruptcy>.

| Total Fund Inflows (Outflows) (\$000's) | | | | | | |
|--|-----------|---------|----------|--------------|-----------|----------|
| Period | Equity | | | Fixed Income | | Total |
| | Domestic | Foreign | Hybrid | Taxable | Municipal | |
| First Quarter | (72) | 26,523 | 8,805 | 27,479 | 9,175 | 71,910 |
| Second Quarter | (52,009) | 44,709 | 2,947 | 25,465 | (1,012) | 20,095 |
| Third Quarter | (57,764) | 31,520 | (12,330) | (51,302) | (3,350) | (93,225) |
| Fourth Quarter | (54,868) | (3,623) | (15,481) | (25,783) | 6,861 | (92,892) |
| 2015 | (164,713) | 99,129 | (16,059) | (24,141) | 11,674 | (94,112) |

Sources: The ICI Institute.

Written By: Matthew Bernardi, Investment Specialist

Fund Flows: According to the ICI Institute, fund flows into municipal bond funds were a positive \$11.6 billion for 2015. This follows a \$31 billion intake in 2014. **The only asset classes** which added funds in 2015 were municipal bonds and foreign equity, while domestic equity, hybrid funds, and taxable bond funds all lost assets. All other bonds funds, except municipals, lost assets during 2015.

Our take: The infusion of dollars into the municipal market can be attributed to a number of reasons, including:

- Continued improvement in the underlying credit health of the municipal market.
- Asset allocation shifts concurrent with demographic shifts.
 - An aging baby boomer generation leading to a higher dependence on tax-exempt fixed income.
- Investors flight to safety over continued uncertainty throughout the global marketplace.

Looking Beyond the Bond Rating

Winter 2015

Nationally recognized rating agencies produce analysis and research on stocks and bonds. They also provide credit ratings for debt of public and private companies including municipal entities, such as state and local governments. The “Big Three,” Standard and Poor’s, Moody’s Investor Services, and Fitch, dominate the industry.

Investors oftentimes use municipal bond ratings as the sole basis for selecting their investments. Utilizing the bond rating as the sole basis for an investment decision is inadequate, in our opinion. The municipal bond market is a very idiosyncratic market with tens of thousands of issuers and hundreds of different issue structures. This means that credit analysis is essential when making investment decisions.

Our portfolio management process starts with credit analysis. This allows specialty firms, like ours, to uncover value for our clients’ portfolios. We treat municipal portfolios as the “bedrock” of each investors portfolio. Credit analysis is a multi-step process, involving analysis of the three pillars: deal purpose, deal structure, underlying credit quality. We analyze audits, financial statements, and demographics when looking at each municipal issue.

Municipal issuers oftentimes are small and it is not economical for them to pay for a rating from the nationally recognized rating agencies. These issues are often overlooked by investors, as they require more time to analyze. Concluding a municipal bond investment lacks investment quality solely because it lacks a rating indicates incomplete credit analysis, in our view.

Non-rated issues often trade at attractive yields (see return chart in right column), given the fact that many market participants are not interested because they do not have resources to do the necessary analysis or are prohibited to invest in these issues within their investment or regulatory guidelines.

Our analysis and expertise allows us to capture these attractive opportunities within the market. Similar to every investment, analysis is not only required before the initial purchase, but must be revised throughout the life of the bond. Lower and non-rated issues appearing on our approved list receive greater and more frequent scrutiny from our credit analysts. These issues are oftentimes buy and hold investments and should only be considered for investors with the appropriate investment plan for such a strategy.

It is important for investors to be cognizant of additional risks that investments may hold, that are not detectable by the ratings themselves. Our history and expertise within the municipal market gives us the ability to analyze each issue with a time-tested, well-developed, granular credit analysis process that has been modified and adapted over the past 30 years. This allows us to capture opportunities within the market, benefiting our clients’ portfolios in the process.

S&P Municipal Bond Non-Rated Index

| Period | Price | % Chg | Annual |
|---------|--------|-------|--------|
| 1 Day | 133.51 | 0.06 | 5.96 |
| 5 Days | 133.63 | -0.02 | -1.05 |
| MTD | 132.87 | 0.54 | 10.94 |
| QTD | 132.87 | 0.54 | 10.94 |
| YTD | 132.87 | 0.54 | 10.94 |
| 1 Month | 132.56 | 0.78 | 9.26 |
| 3 Month | 130.81 | 2.13 | 8.73 |
| 6 Month | 128.31 | 4.12 | 8.24 |
| 1 Year | 127.44 | 4.83 | 4.79 |
| 2 Year | 112.33 | 18.93 | 9.03 |
| 5 Year | -- | -- | -- |

Source: Bloomberg. As of 1/19/16.

Scott Rausch, CFA – Senior Portfolio Manager; (312) 281-2017
John Tranas – Portfolio Manager; (312) 281-2005
Tom Bernardi, CFA – Portfolio Manager; (312) 281-2021

This document has been prepared by Bernardi Securities, Inc. (BSI) for our clients and other interested parties. Within this document, we may express opinions about the direction of financial markets, investment sectors, trends, and taxes. These opinions should not be considered predictions of future results, and are subject to change at any time. Past performance is not indicative of future returns. Nothing in this document represents a recommendation of any particular strategy, security or investment product. This information is provided for educational purposes only and was obtained from sources considered reliable, but is not guaranteed and not necessarily complete. BSI offerings are made by prospectus or official statement only. Income may be subject to state and local taxes and the federal alternative minimum tax. Additional risks associated with investing in municipal bonds include credit risk, interest rate risk, and reinvestment risk. Please consult your tax professional regarding the suitability of tax-free investing. Please consult your investment specialist for more information.

Municipal bonds not FDIC insured • May lose principal • Not appropriate for all investors

Member FINRA/SIPC