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Investment perspectives

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Key highlights:

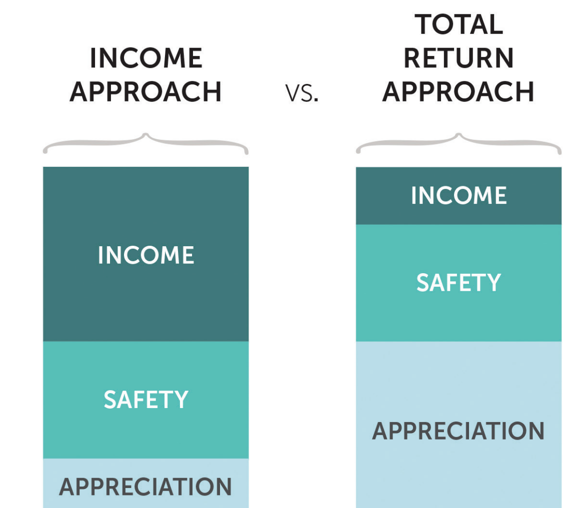
- An income strategy is mainly concerned with providing investors with a monthly distribution.
- Total return incorporates an income component but also seeks to buy bonds that appreciate in value.
- Low correlation and defaults are two final elements to consider.

Clarity in an often misunderstood world

At times, the world of national municipal bond funds can often appear confusing, leaving many observers filled with questions. *Are there different investment approaches? If so, which is the right one for me? Do munis offer any unseen benefits?* These are all valid concerns and we attempt to address them in this latest *Investment perspectives*.

To begin, when considering an investment in a municipal bond fund, investors tend to fall in one of two camps. The first is focused on the monthly payouts made (also known as "coupons") by the fund and is usually referred to as an income approach. The second, which has a total return focus, incorporates an income dimension but also attempts to purchase bonds that appreciate in value over time. Both styles can weigh safety (or the preservation of an investor's capital) in a similar fashion. Selecting one approach over the other (see *Exhibit 1*) is based entirely on the investor's needs and preferences.

Exhibit 1: A fundamental choice in the fixed income world



For illustration purposes only.

Why adopt an income approach?

Investors seeking a muni fund that delivers a competitive level of tax-exempt income[1], while at the same time maintaining its principal, may find an income approach quite appealing. Add in the benefits of diversification (see *Exhibit 5*) and the attraction may increase even more. This approach can also offer the ability to achieve a higher taxable equivalent yield in a low interest rate environment compared to U.S. Treasurys or corporate bonds (see *Exhibit 2*). Regardless of interest rate movements, coupons are continually paid by the bonds in a fund's portfolio, a practice which is sometimes referred to as "coupon clipping".

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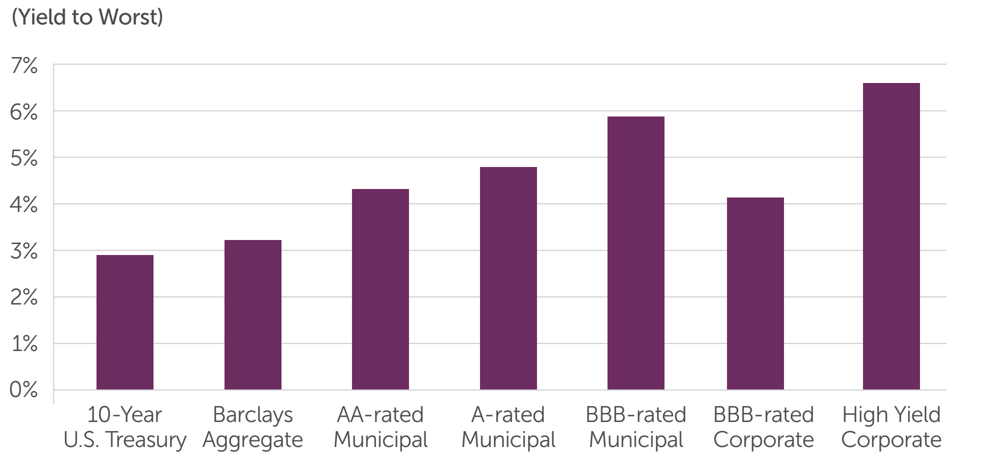
[1] This is on a federal level. There may be some tax advantages on a state level. Investors should consult with their tax advisers for more information about their specific tax situation.

Exhibit 2: Higher after-tax income

(Tax-equivalent yields for selected municipal bond indexes)*

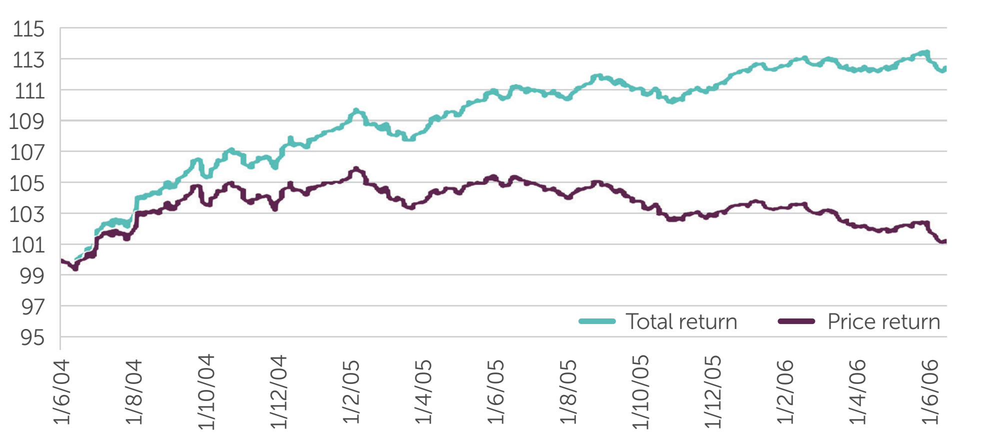


*Source: Bloomberg 5/31/18. Investment-grade municipal data represented by the Bloomberg Barclays US Municipal Bond Index and investment-grade corporate data represented by the Bloomberg Barclays US Corporates Index. High yield municipal data represented by the Bloomberg Barclays High Yield Municipal Bond Index and high yield corporate data represented by the Credit Suisse High Yield Index. *At the 32% tax bracket, the tax-equivalent yield would be 3.69%, 4.19%, 5.11%, and 7.14% for the AA-rated, A-rated and BBB rated Municipal indexes, respectively. Tax-equivalent yield calculation for the municipal indexes above assumes the top marginal tax bracket of 40.8% on investment income, which includes the 37.0% income tax rate and the 3.8% in Medicare tax. This tax rate does not factor in the effect of AMT (alternative minimum tax) or taxes in an investor's individual state. Tax-equivalent yield will vary based on an investor's tax bracket.*

Another factor that may be important is an investor's path towards retirement. As we age, income, both from earnings and individual investments, becomes an important component in any investor's portfolio. Borrowing for a home or college can inflate household debt and finding diversified sources of additional income to help defray these costs can be increasingly important. Embracing an income-focused approach is one way to help mitigate upward spiraling expenses.

Finally, an income approach provides some cushion in an increasing interest rate environment. The last time that the Federal Reserve (Fed) embarked on a tightening cycle prior to the current period was in June 2004. As shown in *Exhibit 3*, although the price component of the ICE BofA Merrill Lynch Municipal Securities Master Index's return fell (which is entirely expected in a rising rate environment), the income portion of the total return (represented by the blue line) rose over the period.

Exhibit 3: Municipal performance during the Fed's last rate increase cycle

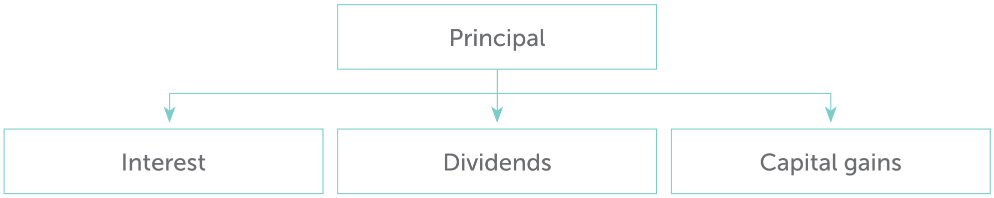


Source: Bloomberg, 7/12/18. Data from 2004-2006. Municipal performance represented by ICE BofA Merrill Lynch Municipal Securities Master Index. Rebased at 100 at start date and updated daily based on index value. Index returns are for illustrative purposes only. Index performance returns do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in an index. ***Past performance does not guarantee future results.***

Why adopt a total return approach?

Total return, the value an investor earns from a fund that includes income plus any capital appreciation due to price changes in its holdings, offers another approach to investing in the municipal bond market. By combining traditional fixed income with an opportunistic investing approach, some investment managers are able to generate income and, at the same time, access opportunities that lead to portfolio growth. Total return essentially combines the portfolio's yield with any price appreciation in its underlying securities (see *Exhibit 4*).

Exhibit 4: Total return investing offers the complete package



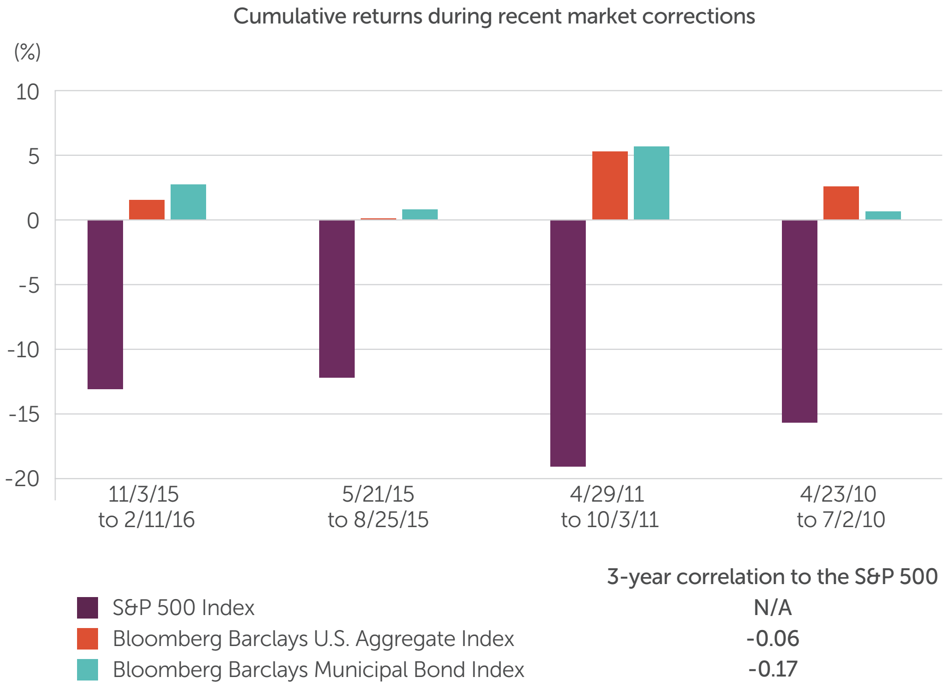
For illustration purposes only.

Flexibility is another tool in the total return approach. By being less restricted by not having to be anchored to higher-yielding positions, a portfolio is able to make tactical decisions, via duration and yield curve placement, to best weather increasing interest rates while seeking the best total return opportunity set for a given market scenario.

A parting word about diversification and defaults

One final consideration for municipal investors is the minimal correlation that the asset class has exhibited in past years to equities. *Exhibit 5* shows the experience during four recent market corrections and not only did municipal bonds show a negative correlation to stocks, but they actually produced positive returns.

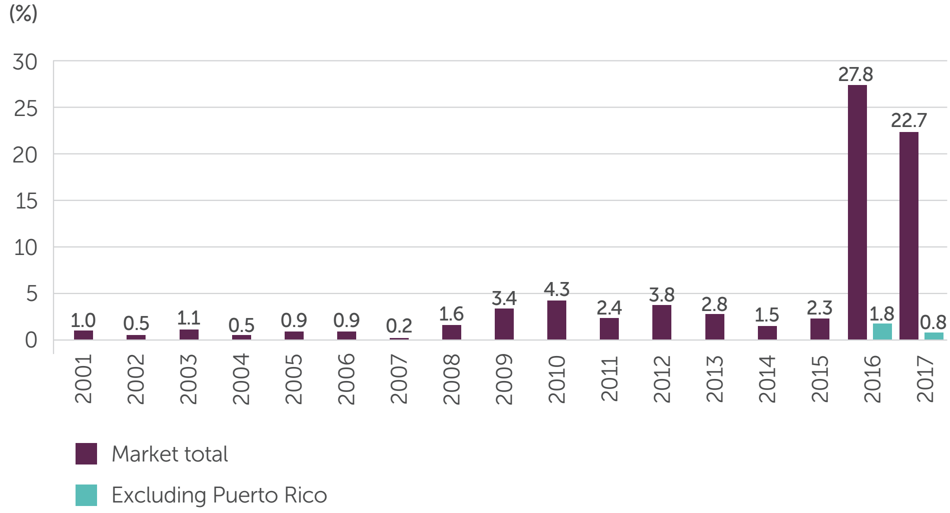
Exhibit 5: Diversified fixed income strategies can help cushion market turmoil



Sources: Bloomberg, 3/31/18. Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the unmanaged S&P 500 with 50% recovery between declines. The returns of the indexes are based on total returns.

Also contributing to a level of security within the municipal market is the low overall default rate in this sector (see *Exhibit 6*), especially when Puerto Rico, which comprised 96% of 2017 defaults, is excluded from the wider market. Safety, meaning principal preservation, clearly becomes less of a concern in a muni fund against this backdrop.

Exhibit 6: Low default rate consistently seen in municipal market



Source: Municipals Weekly, Bank of America/Merrill Lynch Research, 12/1/17. Data represents defaults on the entire universe of bonds, both rated and unrated, and includes Puerto Rico.

Summing it up

A tax exempt platform that offers both income and total return strategies affords investors the benefit of stability combined with the ability to achieve capital appreciation and produce cash flows. Depending upon the needs and situation of an investor, income-generating investments or those with the potential for price appreciation may help meet their requirements. Finally, a municipal bond fund can also offer an attractive diversification benefit and low defaults.

Disclosure

The **Bloomberg Barclays High Yield Municipal Index** covers the high yield portion of the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The **Bloomberg Barclays US Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by US and non-US industrial, utility and financial issuers.

The **Bloomberg Barclays US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Bonds from issuers with an emerging markets (EM) country of risk, based on Barclays EM country definition, are excluded.

The **Credit Suisse High Yield Index** is a market-weighted index that includes publicly traded bonds rated below BBB by S&P and Baa by Moody's. Index results assume the reinvestment of all capital gain and dividend distributions.

The **ICE BofA Merrill Lynch Municipal Master Index** tracks the performance of the investment-grade U.S. tax-exempt bond market. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule, and an investment grade rating (based on average of Moody's, S&P, and Fitch).

The **Standard & Poor's 500 Index (S&P 500)** is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The **Bloomberg Barclays US Aggregate Bond Index** is a market capitalization-weighted index. Most U.S. traded investment grade bonds are represented. Municipal bonds, and Treasury Inflation-Protected Securities are excluded, due to tax treatment issues. The index includes U.S. Treasury securities, government agency bonds, mortgage-backed bonds, corporate bonds, and a small amount of foreign bonds traded in U.S.

The **Bloomberg Barclays Municipal Bond Index** is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

It is not possible to invest directly in an index.

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All investing involves risk, including possible loss of principal. Fixed income investing includes interest rate risk and credit risk. Interest rate risk is the risk that bonds will decrease in value as interest rates rise. As a general rule, longer-term bonds fluctuate more than shorter-term bonds in reaction to changes in interest rates. Credit risk is the risk that bonds will decline in value as the result of a decline in the credit rating of the bonds or the economy as a whole, or that the issuer will be unable to pay interest and/or principal when due. There are also special risks associated with investing in certain types of bonds, including liquidity risk and prepayment and extension risk, or investing in high yield (junk) bonds. There are additional risks associated with the use of derivatives. **Past performance does not guarantee future results.**

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