Tax Efficient Fixed Income Market Commentary

April 2016

Overview

- Volatile global markets create flight to quality
- Crossover opportunity emerges for tax efficient portfolios
- Budget battles in Pennsylvania and Illinois
- States grapple with falling energy prices

First Quarter Highlights

2016 began with a change in market psychology from the manner in which 2015 closed. Markets became fixated on weakening global growth, especially in China and the US, and the impact of weak prices for oil and other commodities. By mid-February a near panic had taken hold. Guided by our longer-term investment process with its emphasis on a rich/cheap valuation framework and grounded in our quarterly planning process, we concluded that markets were overreacting and that the panic was creating opportunity. After much analysis and discussion we entered into a corporate crossover position for many of our strategies.

Interest Rates

Treasury bonds were the biggest beneficiaries of the market volatility, with yields plunging by approximately 50 basis points across the entire yield curve during the quarter. While the municipal market performed well, it couldn't keep pace with Treasuries – for most maturities yields fell 15-20 basis points.

LOOKING AHEAD

Our recent quarterly economic forecasting session supported our view that that an uneven global recovery should keep upward pressure on rates contained. Key themes we will be watching in the second quarter include:

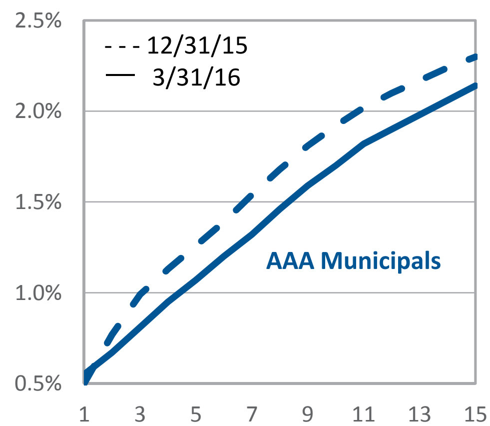
- We expect the tug of war between domestic and global forces to continue, with the outcome uncertain, we prefer a neutral duration posture.
- While we anticipated holding the corporate crossover position for as long as a year, a mean reversion that began near the end of the quarter may offer opportunities to exit sooner.
- Congress continues to hash out legislation to create an oversight board for Puerto Rico with potentially broad restructuring powers. Presently, the outcome of these negotiations remains highly uncertain.
- State budget priorities for fiscal year 2017 are expect to be negotiated in many states during the second quarter.

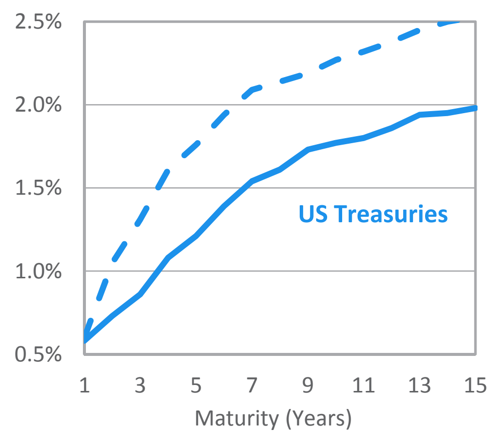
Market Returns

	1Q16
BC Muni Index	1.67%
1 Year	0.32%
3 Year	0.77%
5 Year	1.15%
7 Year	1.50%
10 Year	1.90%
20 Year	1.95%
1-10 Year	1.24%
Prerefunded	0.63%
AAA	1.51%
AA	1.56%
A	1.92%
US Corp 5-7 Year	4.33%
US Treasury 5 Year	2.96%
S&P 500	1.35%

Source: Barclays Capital

Yield Curves





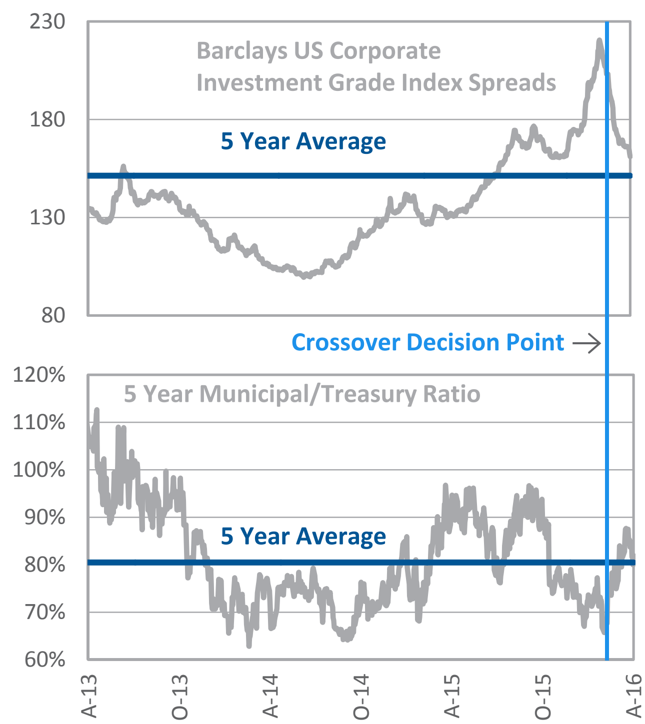
Source: Bloomberg

Muni Market Factors

The technical picture was supportive of municipals during first quarter, as issuance was approximately 12% lower than the first quarter of 2015. While overall issuance fell, there was a 27% increase in new money. This is notable given the reduced new money issuance since the end of the Build America Bond program in 2010. In addition to lighter supply, mutual fund flows were positive every week during the quarter and totaled over $14.6 billion.

CORPORATE CROSSOVER

Much of the time, municipal bonds offer the best after-tax return potential for investors who pay taxes, however a confluence of factors during the last quarter led to a crossover opportunity into corporate bonds. Usually, during times of volatility, we observe municipal bonds cheapen with other non-risk-free assets, but during February municipal bonds continued to perform well despite the sell-off. This created an unusual divergence between municipal and corporate bonds. A careful review of after-tax spread relationships, roll-down analysis and scenario forecasting confirmed the attractiveness of corporate bonds. As a result we entered into a crossover trade for many of our strategies, exiting municipal bonds and replacing them with comparable corporate bonds for approximately 10% of a portfolio. While we anticipated holding the corporate crossover position for as long as a year, a mean reversion that began near the end of the quarter may offer opportunities to exit sooner.



Source: Bloomberg

Credit Insight

In Pennsylvania, a nine-month budget standoff ended, removing some near term uncertainty for downstream issuers like school districts and community colleges. However, the long term challenges facing the Commonwealth will linger into the 2017 budget and beyond. This leaves Illinois as the only state without a budget for the 2016 fiscal year. Agreements that address long term fiscal pressures, particularly unfunded pension liabilities, we believe are likely too be more critical to credit quality than the length of any budget impasse.

Louisiana and Alaska saw their ratings downgraded as falling energy prices continue to place uneven pressure on municipal credit quality. Spreads have widened on both states over the past year. Louisiana has enacted steep budget cuts, relied on one-time revenues and enacted a temporary sales tax increase. More work will be required to close gaps going forward. Alaska, which has an outsized reliance on oil-related revenues, has substantial reserves. These reserves will buy the state time as it faces a fundamental reevaluation of their revenue structure. For Texas, the drop in energy prices has had a more limited impact, demonstrating the depth and diversification of the Texas economy.

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Allocations presented herein are as of the date noted and subject to change.

Index Definitions:

- The Barclays Municipal Bond Index is a rules-based and market value weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody’s, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment-grade. They must have an outstanding par value of at least $7 million and be issued as part of transaction of at least $75 million. The bonds must be fixed rate, have a double date after December 31, 1990, and must be at least one year from maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.
    - Subindices include: 1 Year (1-2 year maturities), 3 Year (2-4 year maturities), 5 Year (4-6 year maturities), 7 Year (6-8 year maturities), 10 Year (8-12 year maturities), 15 Year (12-17 year maturities), 20 Year (17-22 year maturities), 1-10 Year (1-12 year maturities).
- The Barclays US Corporate Bond Index is composed of publicly issued U.S. corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements. To qualify, bonds must be SEC-registered.
- The S&P 500, or the Standard & Poor's 500, is an American stock market index based on the market capitalizations of 500 large companies having common stock listed on the NYSE or NASDAQ.