CAUSE FOR ALARM?

Is there a "looming disaster in the market for municipal debt?" A Barron's contributor asserted as much in "*The Muni Market Time Bomb*" column in the "*Current Yield*" section of the January 29th edition. In our judgment, very real public finance challenges certainly exist, however, greater context is needed. At Appleton Partners, for more than three decades we have engaged in rigorous proprietary research designed to avoid exposing our clients to the issuer specific credit risks highlighted in the column.

Does America face an unfunded municipal pension liability problem? Absolutely. For too long many state and local entities have promised pension obligations that they can no longer afford, particularly as the tax base of certain issuers weakens, investment returns lag pension assumptions, and the gap between pension assets and benefits owed retirees widens. As the piece in Barron's emphasizes, the result, most notably in high profile states like Illinois and New Jersey, as well as cities such as Detroit and Hartford, is woefully inadequate funding ratios. However, acute case specific problems do not translate across the board, either in pension funding status or overall municipal credit quality. The health of individual municipal entities should not be painted with a broad brush, as credit quality is dependent on localized factors such as an issuer's tax base, economic vitality, and fiscal management.

DEFAULTS: A LOOK AT HISTORY

Although there is no substitute for extensive research, municipal credit concerns may be tempered by historical perspective. As the chart below reveals, default rates among municipal issuers has long been minimal, particularly relative to corporate securities. Many municipal issues are backed by broad taxing authority or user-based dedicated revenue streams, although this is dependent on the nature of the bond issue.

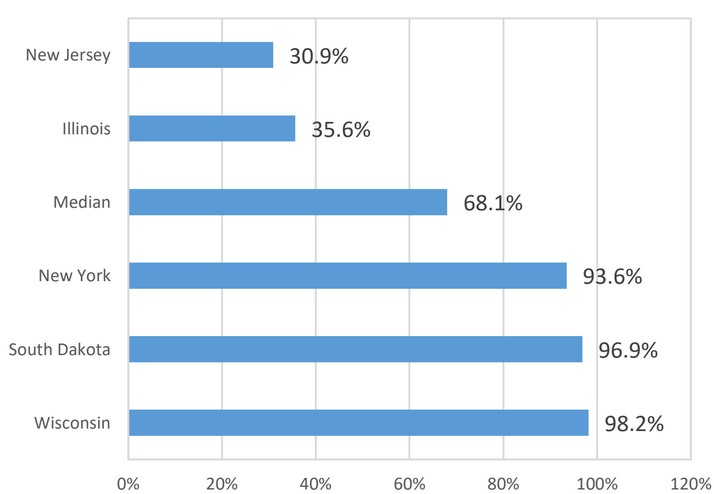
Average Cumulative Default Rate

	All-Rated Issues	Investment Grade Bonds
Municipals	0.15%	0.09%
Global Corporates	10.29%	2.38%

Source: Moody's Default Report, 1970-2016

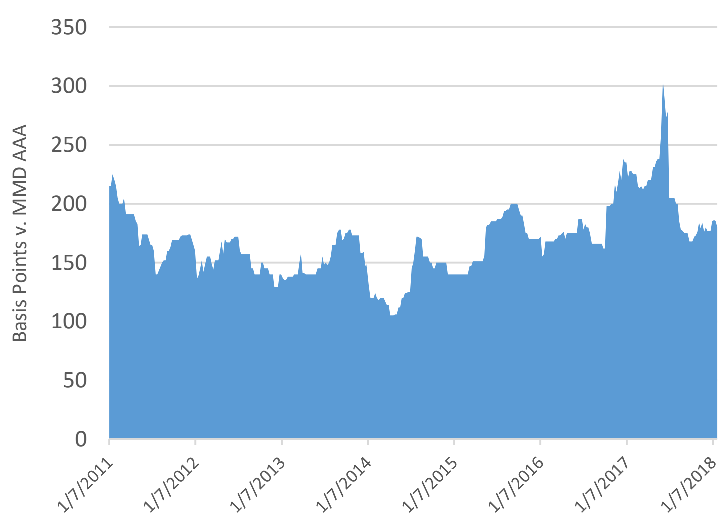
Nonetheless, the performance of a municipal portfolio is significantly influenced by credit trends even in the absence of a default. By investing exclusively in higher grade names based on deep fundamental analysis, we aim to minimize credit related volatility and its impact on investor returns. Credit quality perception, among other factors, significantly influences prices and yields, as illustrated in the accompanying example.

2016 State Pension Funding Status Reveals Significant Distinctions



Source: S&P, "U.S. State Pensions: Funded Ratios Declined Again in 2016," October 18, 2017

Volatility in Illinois 10 Year General Obligation Bond Spreads Reflects Pension Challenges

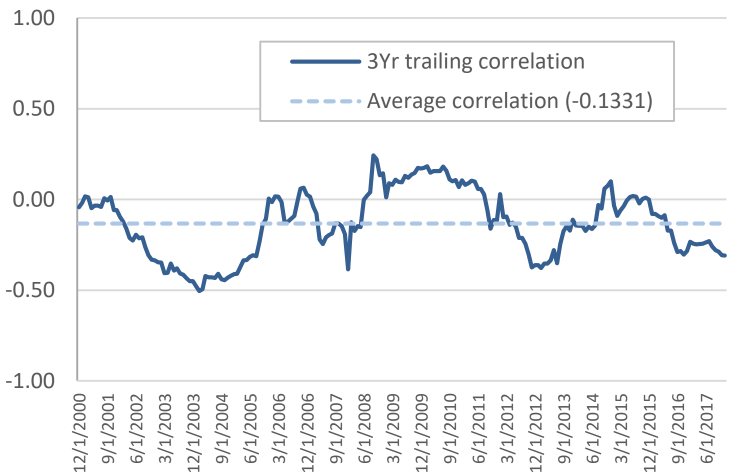


Source: Thomson Reuters

Asset Allocation and Portfolio Efficiency

As adherents to Modern Portfolio Theory will attest, constructing portfolios with lesser correlated exposures, or the degree to which securities or asset classes move in relation to each other, can help risk-averse investors optimize expected return for a given level of risk assumed. As the accompanying chart reveals, municipal securities have historically demonstrated a very low and relatively stable correlation to U.S. equities, thereby making a strong case for inclusion in a diversified portfolio, particularly for investors in high tax brackets. Nonetheless, credit quality remains of paramount importance.

Municipal Bond Correlation to Equities: 2000-Present
Bloomberg Barclays Managed Money
Short/Intermediate Municipal to S&P 500



Source: Bloomberg

An Acute Need for Credit Research

So, what's an investor to do given a desire for tax-exempt income and portfolio diversification in the face of risks associated with certain tax-exempt issuers? How does one differentiate credit stability and investment value from excessive risk? That's where security specific research comes into play. Appleton's research process emphasizes comprehensive quantitative and qualitative analysis, which allows us to develop an independent opinion of each credit based on assessment of underlying fundamentals. In addition to pension funding levels, we look at the health and stability of the local economy, the diversity of revenue sources, the level of financial reserves, and management's implementation and adherence to sound fiscal policies and long-term liability management. In combination, these factors provide us with a holistic view of an entity's credit profile.

As wealth managers, we value capital preservation and only invest in liquid, investment grade securities. Our municipal portfolios seek to avoid credits that we see as introducing excessive risk, regardless of yield.

The value of tax-exempt income, particularly for those in high tax brackets, and the portfolio diversification attributes of municipal securities remain considerable, but potential landmines do exist. While we do not dispute the validity of concerns raised in Barron's, a deeper look at individual municipal issuers and securities, as well as an investment advisor's credit research capabilities, is warranted.