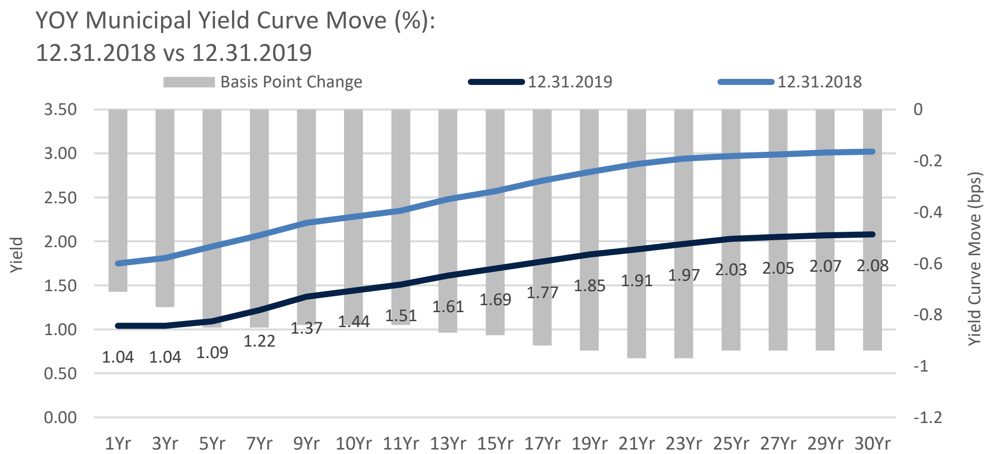
APPLETON PARTNERS, INC.

# OPERATING IN A LOW YIELD ENVIRONMENT

## BACK TO THE 1950'S

Riding a multi-decade fixed income bull market, municipal bond yields have fallen to levels not seen since the Eisenhower presidency. For those not well versed in American political history, that would be the 1950s, a time period that predates the professional experience of nearly all of today's financial advisors.

While this is certainly a challenging time for fixed income investors, as an active fixed income manager with extensive experience in many different market environments, we still see opportunities. Here are some thoughts advisors may want to consider.




Source: MMD

## AN ERA OF YIELD COMPRESSION

Let's start by looking at how we got here. The municipal markets remain in an environment characterized by very strong technical factors. Retail demand continues unabated with January 2020 producing $10 billion of net municipal fund inflows on top of 2019's record total of $93.6 billion. A seemingly insatiable desire for tax-advantaged income has been fueled in part by limitations on state and local tax deductions (SALT).

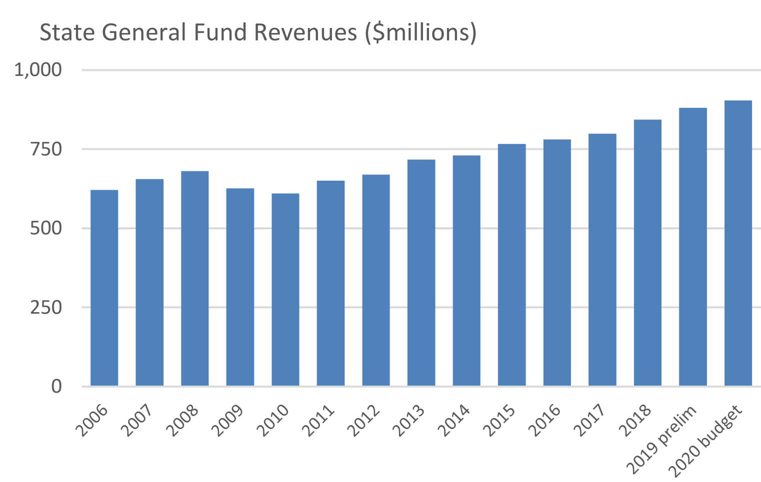
Simultaneously, tax-exempt bond supply remains somewhat scarce, with deals often oversubscribed. Net new municipal issuance declined by $50 billion in 2019, as new issuance of $422 billion was more than offset by maturities, called bonds, coupon payments and taxable advance refunding. A surge in taxable municipals, which are expected to account for upwards of 20% of this year's issuance, is propping up aggregate municipal supply and effectively crowding out the availability of tax-exempt bonds. An accommodative Federal Reserve, intense demand and constrained inventory has driven down tax-exempt bond yields, creating challenges for financial advisors and investors.

## SO, WHAT'S AN ADVISOR TO DO?

While the world has certainly changed since the post-War years, certain market realities remain timeless. At Appleton Partners, we are guardians of our clients' capital. Reaching for yield by compromising credit quality or other risk parameters does not strike us as prudent even though municipal credit conditions largely remain benign.

Fiscal 2019 state general fund revenue grew at a 4.2% year-over-year rate, although this decelerated from the prior year's 6.9% pace[1]. State rainy-day fund balances also reached $72.3 billion at the close of fiscal 2019, up $45 billion relative to 2010's lows[1]. Broadly speaking, these are favorable credit indicators. But let's not forget that buying individual bonds represents an idiosyncratic credit decision. As investors, we focus intently on issuer specific risk. Our white paper, "Differentiating Credit Vigilance from Complacency", emphasized this point late last year.

Simply put, we recommend remaining vigilant about credit quality despite a still healthy economic and municipal fiscal backdrop.




Source: NASBO Fall 2019 Survey

1. National Association of State Budget Officers

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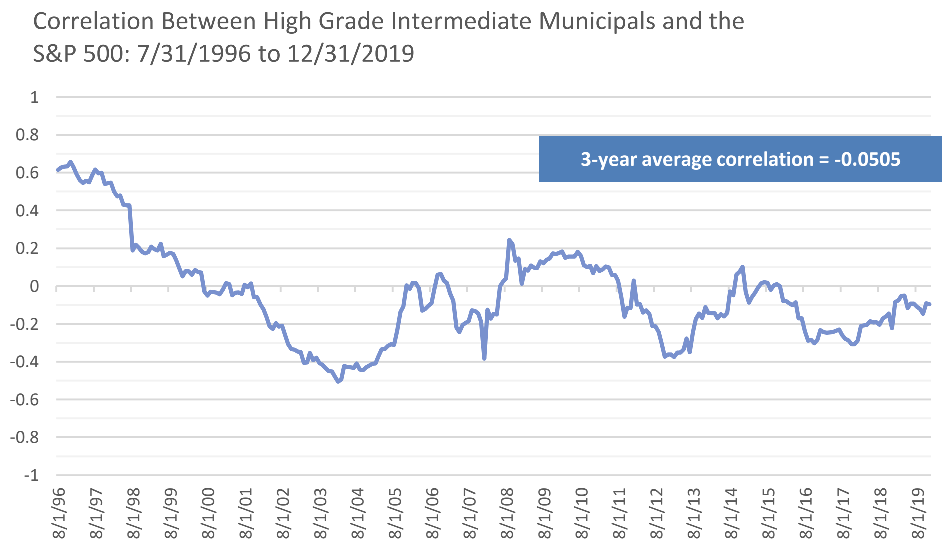
## DON'T FORGET ABOUT PORTFOLIO EFFICIENCY

Even in a low yield environment, it warrants emphasizing that high quality municipals have historically provided valuable portfolio ballast. Relatively low volatility and minimal correlation to equities and other risk assets creates an ability to moderate risks assumed elsewhere in one's asset allocation strategy. Over long periods of time, high grade intermediate municipals have helped counterbalance equity volatility, while also producing tax-advantaged income.

While the realist in us recognizes that income is constrained by today's yield environment, we feel the time is right for active management and offer several tax-exempt ideas and considerations.




Source: Bloomberg. Municipal returns used in correlation analysis reflect the performance of the Bloomberg Barclays Managed Money Short/Intermediate (1-10 Years) Index from its inception on 7/31/93.

## FIND THE SWEET SPOT ON THE CURVE

We see value along the 6-12Yr portion of the municipal curve. The spread between 2-10Yr AAA municipals widened by 20 basis points to 40 basis points during Q4 '19 before receding modestly to 32 basis points at the end of January, creating considerably greater steepness than is available at shorter and longer maturities. By contrast, only a 1 basis point yield spread separated 2 and 5Yr issues at month's end, while longer maturities (12+ years) also flatten out.

## DON'T BE OVERLY CONSTRAINED BY BORDERS

Complementing state preference portfolios with out-of-state bonds also offers an ability to help clients enhance after-tax yield and total return. For obvious reasons, staying "in-state" is a common tax-exempt objective. However, the availability of creditworthy, liquid bonds in most states is limited, and certain states are also currently trading quite rich. This opens the door to relative value tradeoffs that can enable investors to enhance after-tax returns by looking beyond a client's home state.

Looking at two recent AAA-rated, bond offerings of similar structure illustrates this point:

- Southern CA Metropolitan Water District, 10/1/30 callable 10/1/29 was offered at 1.00%
- Richardson, TX GO, 2/15/30 callable 2/15/29 was offered at 1.36%

A high-tax bracket California resident buying the Richardson, TX bonds would be subject to a 13.3% state income tax, leaving a net after-tax yield of 1.18%, still well in excess of the comparable in-state bond.

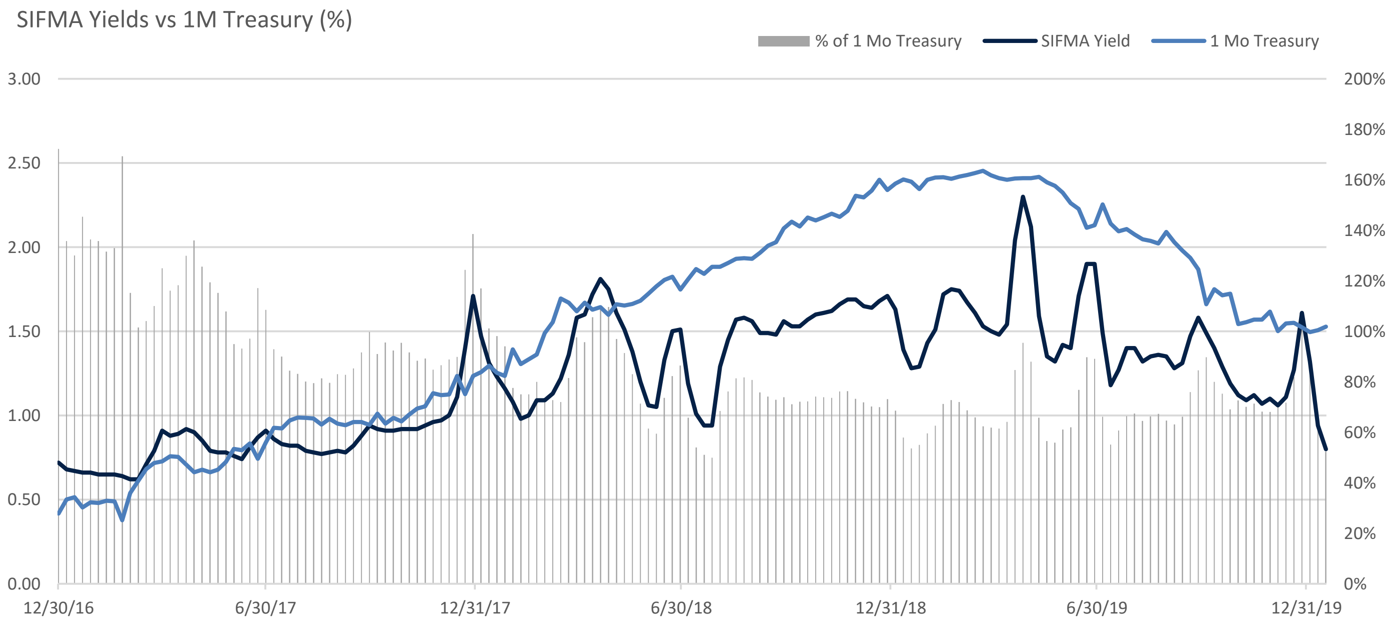
Our municipal SMA strategies emphasize client customization based on state of residence and other personal factors. We start by communicating "in-state" exposure targets that factor in individual tax needs, local bond availability and market conditions at the time of investment. While there is no single optimal solution, looking beyond one's home state can be beneficial.

# Operating in a Low Yield Environment

## Energizing Cash Pays Dividends

With municipal rates at the front-end of the curve falling well below 1%, one might understandably view short-term holdings as merely a parking place. Despite a low short-term yield environment, we see opportunities to add income through tactical flexibility and patience.

Variable Rate Demand Notes (VRDNs) are municipal instruments with coupons that reset daily or weekly that can effectively complement high quality short-term municipals in tax-exempt portfolios. VRDN yields are highly influenced by short-term supply and demand changes. At times, the SIFMA Municipal Swap Index, a 7-day high grade market index comprised of tax-exempt VRDN reset rates, maintains a considerable yield advantage relative to municipals and Fed Funds on a tax-adjusted basis. At other times this is not the case, which speaks to the value of actively managing tax-exempt cash and equivalents.




Source: Bloomberg, Securities Industry and Financial Markets Association, and Appleton Partners, Inc.

Another strategy we are discussing with advisors involves swapping out very short municipals for Treasury Bills. While all bond yields are relatively compressed, looking at short-maturity options on an after-tax basis can be revealing. For example, 1Yr T-Bills currently maintain a 0.23% yield advantage vs. AAA municipals tax-effected at a 32% tax rate. In a yield-starved world that's hardly worth ignoring. For investors paying a 40.8% rate, the differential is a much narrower, but still positive at 0.05%.

| 1 Year Maturity Comparison | 1/31/2020 | 12/31/2019 | 12/31/2018 |
|---|---|---|---|
| US Treasury | 1.44% | 1.58% | 2.60% |
| AAA Muni @40.8% tax rate | 1.39% | 1.76% | 2.96% |
| Spread | 0.05% | -0.18% | -0.36% |
| AAA Muni @32% tax rate | 1.21% | 1.53% | 2.57% |
| Spread | 0.23% | 0.05% | 0.03% |

Source: Bloomberg, MMD, Appleton Partners, Inc.

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## PREPARE FOR THE NEXT CYCLE

Our base-case 2020 forecast for the 10Yr UST lies in a 1.60-2.10% range. As we write, the 10Yr is trading at the bottom end of that range (1.60%). While we don't anticipate a sustained rising rate environment anytime soon, our portfolios are positioned to help insulate against rising rates.

For one, we like premium coupon bonds. These bonds have slightly lower durations than par bonds with similar maturity and call features due to the higher coupon and greater associated cash flows, thus they should be slightly less volatile than lower coupon bonds.

We are also highly selective in the callable bonds we purchase and aim to have only 2 to 4 years between call and maturity date. We tend to avoid bonds with short calls and longer stated maturities given significantly increased extension risk and volatility exposure should interest rates increase. Extension risk can lengthen the duration of your portfolio at an inopportune time should yields rise enough to cause a bond priced to call to extend and subsequently price to maturity.

## STAY THE COURSE, BE ACTIVE, AND COMMUNICATE

Muted yields may not excite investors, but in today's environment several points are worth reinforcing. Maintaining one's long-term asset allocation strategy and prioritizing tax efficiency are important regardless of market conditions, and high-grade municipals offer tangible benefits in this regard.

We expect active bond management to prove valuable over the next market cycle and don't see much value in locking in today's yields through passive strategies. Instead we seek to capture pockets of opportunity in dynamic markets, a process that demands a clear understanding of client needs, as well as liquidity and tactical flexibility. You may need to look a little harder, but an ability to add value still exists.

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