The Investor's Edge

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C.W. HENDERSON & ASSOCIATES, INC.
INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

Cautious Federal Reserve

The Fed's forecast after their December twenty-five basis point increase in the targeted Federal Funds rate was for four additional tightening moves in 2016 as the strengthening U. S. economy continued to foster employment gains and inflation climbed towards the Fed's 2% target. We commented in our last newsletter that four moves seemed unlikely given sluggish global growth and still muted inflation. Our presumption proved correct. At the conclusion of the mid-March Open Market Committee meeting, Fed Chairwoman Yellen indicated that global economic and financial uncertainty pose risks to the U.S. economy and justify a slower pace of interest rate increases. She specifically pointed to slowing growth in China and weak oil prices as cautionary indicators prompting the need for patience. Market forecasters and the futures market are now suggesting that only one tightening move is probable this year, and later in the year rather than earlier. Fed guidance continues to emphasize that future moves will be data-dependent with inflation and employment gains being key factors in their consideration.

Our view has not changed over the past quarter. We continue to expect moderate U.S. economic growth with RGDP advancing at a 2+% rate accompanied by additional employment gains and inflation trending slightly higher but remaining moderate. One Fed move this year, perhaps two at most, appear probable.

Longer municipal yields were relatively stable during the quarter with a bias towards lower levels as the Fed's caution became apparent. Ten year prime municipal yields fell by about 25 basis points from the year end level and ended March at 1.70%. Short tax-exempt rate movements have been more dramatic. The Securities Industry and Financial Markets Assn. (SIFMA) index of seven day variable rate demand note rates rose from 0.01% in late February to 0.40% at the end of the quarter. The move partially reflects money market fund liquidations to meet April tax obligations, but also concern over SEC regulatory restrictions that could impact money market fund liquidity (more below).

The rise in short rates has caused the tax-exempt yield curve to flatten. The spread between five and ten year prime yields has fallen from an average spread of 111 basis points over the past several years to 64 basis points, the smallest spread since 2008.

Given low levels of nominal yields and all but nonexistent real interest rates, we are continuing to structure portfolios with conservative durations targeted at about 3.50 years. While the near term outlook is for longer rates to remain relatively stable, we feel that yields will ultimately be pressured higher as the economy continues to improve.

Altered Money Market Fund Operating Rules

As we mentioned briefly in our last newsletter, the SEC altered Rule 2a-7 regarding the management of money market funds. Greater credit diversification is required and, more importantly, fund trustees could impose withdrawal restrictions on non-U.S. Treasury and government funds. Exit fees up to 2% and restrictions on withdrawals (gates) on prime money market funds (including municipal funds) can be imposed if weekly liquidity falls below 30% of

fund assets. If a prime money market fund's weekly liquidity falls below 10%, a minimum 1% liquidity fee would be required. Weekly liquid assets include cash, U.S. Treasury securities, certain other government securities with remaining maturities of sixty days or less and securities that can be converted into cash within one week. Non-government institutional money market funds (funds with investors that are not "natural persons" must have floating net asset values calculated to four decimal places (e.g. 1.0005; 0.9995; etc.). Compliance with the new rules must be in place by this fall.

Money market fund offerings will likely be arrayed as follows:

Fund Type	Allowable Investors	NAV	Fees and Gates
Treasury & Government	All investors	Constant	Permitted/Unlikely
Retail Prime	Natural Persons	Constant	Insufficient Liquidity
Retail Tax-Exempt	Natural Persons	Constant	Insufficient Liquidity
Institutional	All Investors	Variable	Insufficient Liquidity

It is important to recognize that the industry remains in a state of flux as providers determine the best courses of action for each of their respective circumstances. Low rates have generally made money market fund management unprofitable in recent years. Lack of profitability in conjunction with tighter rules could prompt some sponsors to limit fund availability, stop accepting new investors or close some funds. We feel that the prudent move at this time is to have client cash invested in custodial Treasury or government funds to maximize safety and flexibility. We will continue to monitor industry developments in the months ahead. We also note that C.W. Henderson's short term product provides an alternative for cash investments.

Best Execution

Under the Investment Advisers Act, registered investment advisers must seek to obtain best execution when trading in clients' accounts. Price is the major consideration, but advisers must also consider the full range and quality of a broker/dealer's capabilities including research provided, execution capabilities, bid/ask spreads, financial responsibility and responsiveness. It is generally acknowledged that smaller retail bond trades are executed less efficiently than large institutional block trades. Part of the reason is that professional traders can readily assess the value of a security's credit quality, structural characteristics and price. A broker salesperson may need to make only a few calls to place a large block of bonds with institutional investors. In contrast, a retail salesperson will likely need to solicit numerous prospects to place a block of bonds. The potential for an unfavorable market move during the longer sales process could eliminate a brokerage firm's profitability. Wider spreads provide compensation for this risk.

The General Accounting Office studied municipal trading efficiency in 2010 and subsequently released their report. As shown in the table below, they concluded that individual investors purchasing small blocks of bonds generally pay higher prices when purchasing municipal securities. Their analysis indicated that in 2010 the average markup for a $20,000 par trade was around 1.80% compared to 0.10% for trades of a million and higher. To put this in context,

consider a 20,000 par purchase of a ten year maturity non-callable bond with a 5.0% coupon. If priced at a 2.50% yield to maturity, the dollar price of the bond would be 122.00. A 1.80% markup on the bond increases the dollar price to 124.20 and reduces the yield to maturity to 2.28%. Comparable discrepancies were also found when retail investors sell small blocks of municipal bonds.

In addition, the GAO analysis demonstrated a wider range of prices for smaller trades than for larger trades. Larger block trades were more concentrated while smaller trade prices were more dispersed. The following table also includes this data.

Average Relative Prices and Price Dispersion for Newly Issued Fixed-Rate Municipal Securities Sales in 2010:

Trade Amount	Avg. Relative Sales Prices	Avg. Dispersion of Purchase Prices
$1,000 - $10,000	101.9%	1.24%
$10,000 - $20,000	101.8	1.05
$20,000 - $50,000	101.4	0.88
$50,000 - $100,000	100.9	0.46
$100,000 - $250,000	100.4	0.18
$250,000 - $500,000	100.3	0.13
$500,000 - $1 million	100.2	0.11
$1 million - $5 million	100.1	0.11
$5 million and over	100.1	0.07

The GAO report referenced research indicating that pricing variances between large and small trades are not entirely accounted for by dealer costs. One study the GAO cited suggests that the lack of price transparency in the diverse municipal market allows better informed investors to obtain more favorable trade prices. Institutional investors' credit knowledge gained from in-house credit staffs, constant engagement in the market, frequent interaction with a broad range of dealers and access to Bloomberg and online trading systems provide professional traders with increased knowledge and bargaining power.

C.W. Henderson's trading team, supported by the Firm's credit analysis group, has the experience, tools and market contacts necessary to critically assess available securities offerings. Best execution is examined quarterly by evaluating sample trades transacted by the Firm's trading desk.

Tax-Loss Trading Adds Efficiency

In conjunction with our daily professional trading, C.W. Henderson's active management of municipal portfolios has the potential to add value by taking advantage of market inefficiencies, changes in the shape of the yield curve, varying credit spreads, etc. Tax loss trading represents an additional component of active management. The buyer of a municipal security acquires an option that can be exercised, the option to sell the security before maturity. Liquidation of a bond trading below its amortized purchase price locks in a tax loss that can be used to offset

gains in other bond trades or in other segments of a client's overall portfolio. A buy and hold strategy discards this option.

The most favorable tax-loss trade is one that locks in a short-term loss but long-term losses can also add significant value by reducing overall tax liabilities. Determining when to sell and at what price requires judgement regarding the likely trend in interest rates, credit quality comparisons between bonds sold and repurchased and relative value assessments. Tax loss trading is an integral part of active bond management process that C.W. Henderson aggressively pursues when market conditions provide opportunities.

Chicago's Pension Challenge

The Illinois Supreme Court recently struck down Chicago's pension reform plan that would have raised retirement ages, reduced cost-of-living adjustments and required city workers to contribute more to their retirement plans. The court determined that the reforms violate a provision of the state constitution that bans diminishing existing pension benefits. The decision was not surprising as the court rejected a similar State of Illinois pension reform plan. Chicago enacted a property increase last year to support unfunded pension liabilities and additional tax increases may be needed if a new plan to moderate pension obligations cannot be developed.

A comprehensive review and assessment of Chicago's financial situation, prepared by our credit research group, is available on the C.W. Henderson website (www.cwhendereson.com).

Puerto Rico Developments

The U.S. House of Representatives developed a plan designed to allow the Commonwealth to restructure some of its debt under the auspices of a federal oversight board. The board would have power to approve or reject budgets developed by the governor and legislature. The legislation also provides for an automatic stay of litigation. Ceding control to an oversight board is unpopular with Puerto Rico's political leaders. However with a $400+ million debt service payment due next month and $2 billion due in July, the need for a workout plan is critical. On another front, Puerto Rico brought a case to the Supreme Court in an attempt to gain access to bankruptcy proceedings. A Supreme Court decision is anticipated this summer. Despite never having purchased Puerto Rico securities and liquidating inherited commonwealth bonds, we continue to monitor developments to assess Puerto Rico's impact on the broader municipal market.

Firm News

April marks C.W. Henderson's twenty-fifth anniversary. We are extremely thankful for the confidence and support of our clients, business associates and friends through the years.

Craig W. Henderson Thomas L. Mallman, CFA Matt Andrews

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