Capital Gain/Loss Management

March 2015

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

Tax efficiency is a core component of the C.W. Henderson & Associates active management investment process. Capital gains realization is controlled while capital losses are actively pursued when available. Periods of rising rates provide opportunities to realize losses that can offset gains in other components of clients' portfolios or carried forward for later use. Gains realization is at times appropriate when adjusting portfolio durations in accord with the Firm's interest rate outlook, liquidating holdings to meet client cash needs and executing advantageous trades that enhance credit quality and/or improve portfolio structures. In these instances the focus is on realizing only long term gains. In instances where our analysis indicates that the credit quality of a holding is declining, we will eliminate the holding in a timely manner with capital gain/loss considerations being a secondary consideration. We may also execute favorable trades and generate capital gains if we are aware that the client has offsetting losses elsewhere in their overall portfolio.

As shown below, longer tax-exempt rates rose sharply in 2008 in response to investor concerns about the financial integrity of municipal governments during the financial crisis, illiquidity in the auction rate preferred market, municipal insurer downgrades, etc. Economic sluggishness and massive monetary ease caused yields to trend significantly lower during the following four years. We reduced portfolio durations to moderate volatility risk and increase defensiveness during this latter period. The trend toward lower rates was abruptly interrupted in 2013 when yields rose in reaction to concerns regarding the end of quantitative easing. Forecasts of additional rate increases last year proved incorrect and yields again fell as global growth declined. We further reduced our duration target last year.

Prime Municipal Yields

	12/31/07	12/15/08	12/31/12	9/15/13	12/31/14
1 Year	2.93%	0.90%	0.21%	0.19%	0.17%
5 Years	3.22	2.98	0.79	1.62	1.31
10 Years	3.16	4.23	1.70	3.09	2.05
15 Years	3.98	5.11	2.13	3.86	2.36
20 Years	4.21	5.49	2.44	4.27	2.60

The rise in rates in 2008 and 2013 provided opportunities to capture available capital losses in those years while also restructuring portfolios. Net short term losses of $8.3 million were generated in the accounts comprising our intermediate composite in 2008 and an additional $12.1 million losses were generated in 2013 that equated to 49 and 62 basis point respective return adjustments. Assuming maximum federal short term capital gains rates in these two years (35.0% in 2008 and 43.4% in 2013), tax adjusted returns were enhanced as a result of C.W. Henderson's proactive management. The benefit of this activity is not included in reported returns.

To illustrate the efficiency of the C.W. Henderson active management approach over the entire seven year period, representative accounts with assets ranging from one to ten million were selected and analyzed during the period from 12/31/2007 through the end of 2014. The accounts analyzed were reasonably stable with limited additions and withdrawals. Realized gains and losses were not distorted by securities sales needed to meet cash withdrawal requests. Significant net losses were generated in 2008 and 2013. Capital gains were realized periodically in other years as restructuring was implemented to improve quality and reduce portfolio durations, especially in 2012 in advance of the increased tax rates that became effective the following year. The average duration of these accounts was 4.56 years in late 2008. By the end of 2014 average account duration had been reduced to 3.12 years to lower volatility risk.

Realized short term and long term gains and losses in each account were tallied year-by-year. The basis point impact for each year was adjusted for the maximum applicable short term and long term federal capital gains tax rates. The average compound annual return for these accounts over the seven year time period was 4.09% while the tax adjusted compound annual return was 4.08%.

In effect, significant portfolio restructuring that increased defensiveness and upgraded quality was implemented without negatively impacting clients' tax burdens.