Benefits of Geographically Diversified Portfolios

May 2016

C.W. HENDERSON & ASSOCIATES, INC.

INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

Focusing Solely on In-State Municipal Bonds is Often Not the Best Strategy

C.W. Henderson & Associates, Inc. (CWH) manages about $2.90 billion of high quality tax-exempt municipal bond portfolios for clients. Many of those clients are residents of states with high income tax rates such as California, Minnesota, New York and Oregon. These states are examples of "specialty states," states that exempt the state income tax on in-state bonds for in-state residents. Clients that reside in these states often request that CWH construct a municipal portfolio that is 100% invested in their specialty state. While it is desirable to avoid state taxes, purchasing securities solely from issuers in the state where one resides may not maximize a client's return on an after state tax basis.

For multiple reasons, CWH prefers to assemble nationally diversified client portfolios. This commentary discusses yield break even points on out of state bonds, the benefits of geographic diversification and unique bond structures CWH employs to generate alpha.

Yield Break Evens

The deductibility of state taxes on federal returns provides investors with incentive to geographically diversify their portfolio. The below chart depicts the equivalent out-of-state municipal yield necessary to achieve a "break even" yield when compared to purchasing an in-state bond. It assumes residents in the highest federal tax bracket of 39.60%. Due to the demand for in-state bonds from residents in states with high tax rates, yields on these bonds tend to be lower than on bonds issued by municipal entities in states with low or no taxes. CWH can purchase high quality bonds from "non-specialty" states such as Florida, Texas, Washington and Wisconsin and allocate them to specialty state client portfolios – typically picking up enough yield to more than offset the state tax and giving clients the added benefit of geographic diversification.

While CWH strives to utilize in-state municipal bonds in accounts of high state tax residents (mostly on the longer end of portfolio structures), we often find that out of state municipals provide better absolute return for clients, especially given the current low prevailing level of municipal interest rates. If municipal interest rates were significantly higher the required yield pickup to break even on out of state municipals would certainly increase. Client portfolios may be better served at that point by increasing allocations to in-state securities.

State	Maximum Tax Rate	Highest Inverse Fed Tax Bracket	Effective Tax rate	Approx. 10yr AA Yield	Yield to Break Even	Approx. 5yr AA Yield	Yield to Break Even
CA	13.30	60.40	8.03	1.78	**1.92**	1.12	**1.21**
MN	9.85	60.40	5.95	1.73	**1.83**	1.07	**1.13**
NYC	12.696	60.40	7.67	1.90	**2.04**	1.20	**1.29**
OR	9.90	60.40	5.98	1.73	**1.83**	1.07	**1.13**

**Data as of 5/23/2016*

As described above, today a California resident in the highest tax bracket needs to earn just 14 basis points more on an out of state municipal bond in ten years versus an in-state California bond to break even. In five years the same resident needs to earn only 9 basis points more to break even. Both are based on "AA rated" market yields. Currently, ten year AA California bonds would trade at approximately 15 basis points over the AAA scale. The yield pickups necessary to achieve a break even return, or to increase one's after tax total return, are readily available while investing in securities from high quality municipal issuers.

Benefits of Geographic Diversification

Geographic diversification is appropriate both to reduce concentration risk and to provide opportunities for return enhancement through the use of high coupon bonds with current calls and other attractive securities that match the parameters of the strategies we utilize in the broad, national market.

Investing an entire municipal portfolio in one particular state is essentially putting "all of your eggs in one basket." Credit deterioration of one issuer may have a profound destructive impact, albeit often temporary, on all issuers in the state. Orange County California's 1994 bankruptcy, a result of heavy borrowing and risky investments, led to sharply lower prices and illiquidity for numerous California issuers. Some mutual funds specializing in California debt dropped by almost 2.5% according to Lipper Analytical Services. Detroit's 2013 bankruptcy, and the doubts regarding the State of Michigan's willingness to assume outstanding general obligation debt, drove up the borrowing costs for other municipalities in the state. In the days and weeks after Hurricane Katrina devastated the Gulf Coast region in 2005, mutual funds that owned Louisiana debt universally underperformed the broader market. Nationally diversified portfolios reduce the likelihood that an investor will be adversely impacted due to concentration risk.

High Coupon Bonds with Current Calls

CWH purchases high coupon/short call bonds in the short component of client portfolio structures. These high coupon securities provide both price stability as well as the potential for enhanced returns if the bonds do not get called. Assume a California resident in 13.30% tax bracket purchases a 5.00% AAA rated Texas bond that is due in six years and callable in six months at par. If CWH pays $102.250 for the bond, the yield to call will approximate 0.50%. During the first six months that the security is held, there will be an income return of 2.50% (half the annual rate) while the 2.25% premium paid for the bond will amortize. The total return for the six month period will be 0.25% (0.50% annualized). If the bond is not called, the return for a year will be 0.25% for the first six months and 2.50% for the second, resulting in a return for the entire year of 2.75%. A 2.75% return for a California resident in the highest tax bracket is the approximate equivalent return of 30 year AAA rated municipals on a net after state tax basis. Except in the case of a dramatic rise in interest rates (400+ basis points) the bond is likely to always be priced to the next short call which limits price volatility.

Constructing defensive, nationally diversified portfolios that take advantage of market inefficiencies, as opposed to taking on significant credit or interest rate risk, has allowed C.W. Henderson & Associates, Inc. to achieve attractive returns for our clients for over twenty five years.

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