GW&K INVESTMENT MANAGEMENT

PORTFOLIO MANAGER Q&A | APRIL 2021

2-8 YEAR ACTIVE MUNICIPAL BOND STRATEGY

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ABOUT OUR STRATEGY

We believe the key to successful bond management is to protect and grow both principal and income. We also believe that an active, national approach provides greater potential to reduce risk and maximize after-tax returns.

GW&K's 2–8 Year Active Municipal Bond Strategy emphasizes bottom-up research to target investment grade short to intermediate maturity bonds, and maintain flexibility to position portfolios to take advantage of market trends. The Strategy seeks to preserve and enhance capital while protecting the income stream.

- **Strategy Assets: $863 MM**
- **GW&K Municipal Bond Assets: $34,728 MM**

Assets as of 3/31/21

BRIAN T. MORELAND, CFA

Why should investors consider an allocation to municipal bonds?

Mr. Moreland: There are a number of attractive benefits to municipal bond investors looking for tax-free income and preservation of capital. Municipal bonds, for example, generate interest that is exempt from federal taxes. In addition, bonds purchased in a client's state of residence are also exempt from state taxes.

This tax advantage is largely attractive to investors in higher tax brackets, especially for those residing in high tax states such as California and New York. The tax-exempt market has had historically low default rates, less volatility and low correlation to many other asset classes.

Looking at the suite of municipal bond strategies that GW&K offers, where does this Strategy fit relative to the others? How do you determine which Strategy is most appropriate for a particular client?

Mr. Moreland: We believe the 2-8 Year Active Municipal Bond Strategy is ideally suited for investors who want to be more defensively positioned within the municipal bond market, but still have the benefit of GW&K's active management style. Our 2-8 Year Strategy is more conservative in duration and interest-rate risk relative to GW&K's other municipal bond Strategies. The objective is to maximize total return opportunities across the front end of the yield curve. Portfolios will generally be of higher quality versus our flagship Intermediate Municipal Bond Strategy.

How does active management benefit investors in the Strategy? Why should an investor choose this Strategy over a passive approach?

Mr. Moreland: Our active approach has the flexibility to capitalize on changes in the yield curve and we can reposition any amount of our portfolio to lock in higher yields and cheaper bonds for our clients. We believe that active management is the only way to manage interest rate and credit risk to achieve greater risk-adjusted returns.

Let's not forget that municipal bonds are largely owned by retail investors who pay taxes. Whether constrained by capital gains taxes or simply investment philosophy, most investors hold bonds to maturity. This approach exposes the investor to reinvestment risk and the loss of income. Moreover, passive strategies give up any potential for capital appreciation or growth of principal. We do not believe that par value is the best a bond investor can do! The best way to protect a client's income stream is by growing the principal. Even in a rising interest-rate environment, a bond ladder or passive approach waits for a bond to come due before reinvesting that given percentage of their portfolio.

GW&K has been managing municipal bond portfolios for nearly half a century. We have remained true to our bottom-up, active and research intensive investment approach since our founding in 1974. Active management, research intensive, capital preservation, national approach, high-quality portfolios, and tenured management are elements of all of our municipal bond Strategies, and are important contributors to our long-term success and lasting client relationships. Our team averages 22 years investment experience and 18 years with the firm. We have weathered many market cycles together.

How does the 2-8 Year Active Municipal Bond Strategy differ from similar strategies in the industry?

Mr. Moreland: GW&K's 2-8 Year Active Municipal Bond Strategy focuses primarily on the 2-8 year maturity range of the curve, but maintains flexibility to shift positioning to exploit relative value opportunities up to 10 years. Through active management in this largely inefficient market, we have demonstrated that our Strategy can generate capital appreciation and higher total returns over a passive laddered strategy. We adjust duration and curve positioning based on the level of rates, steepness of the yield curve, relative valuations and other factors. We aim to protect and grow both principal and income over time.

What level of credit quality does this Strategy focus on?

Mr. Moreland: We only invest in investment grade securities. The Strategy primarily invests in securities rated "A" or higher and typically has an average credit quality of "AA."

How important is research and independent credit analysis to the Strategy? What metrics do you consider before investing in a particular municipal bond?

Mr. Moreland: Unlike many other municipal bond investment managers, we rely on our own internal research, not on ratings agencies or bond insurance, and believe independent research is vital in understanding the structure and risk of an investment in different market cycles.

The municipal bond market is vast, highly fragmented and inefficient. It consists of over 50,000 different issuers across various sectors. We consider many different factors depending on the issuer and sector, including, its economic profile, financial drivers, debt metrics, security features, liquidity and spread analysis. Each credit at the firm is reviewed annually with some as frequently as quarterly. Our analysts assign an internal rating and outlook on all purchases.

Our research team consists of five seasoned analysts with experience in all sectors of the municipal market and are dedicated solely to municipal bond analysis. Collectively, they average 14 years of investment industry experience.

Each of our analysts covers approximately 100 individual credits. Every name that we own across our municipal portfolios is known to and followed by our analysts. We believe such comprehensive research coverage and surveillance may not be possible in larger firms who may own thousands of credits.

The benchmark for the Strategy is the Bloomberg Barclays 5-Year Municipal Bond Index. Why this benchmark versus another, such as the ICE BofA 3-7 Municipal Bond Index?

Mr. Moreland: We look at both of these Indexes to determine relative positioning in the market, but do not manage to one index or the other. More often than not, the benchmark index is chosen by the client or the financial advisory platform. One way we add value is by buying bonds shorter and longer than the benchmarks. Historically, however, the duration of the Strategy is more in line with both of these Indexes.

How does ESG fit into your process? What can you tell me about how you evaluate bonds?

Mr. Moreland: We believe that municipal bonds are a natural fit for ESG portfolios given the public service mission of the issuing entities. Our approach fully incorporates ESG analysis into our overall credit process through a comprehensive and forward-looking assessment of risk. Each analyst scores all of their assigned credits based on ESG factors. ESG scores are applied based on the factor weightings respective to each sector within the market.

In the municipal bond space, there are no independent sources of ESG ratings. We therefore utilize a proprietary ESG methodology which scores issuers on a 1-5 scale based on how well they are addressing numerous ESG considerations within their particular sector of the market, with a 1 showing material deficiencies and a 5 showing best practices.

Governance, or the "G" in ESG, plays a significant role in all ESG scores, but Social and Environmental factors can vary based on the sector (e.g., electric and water utilities will have a greater environmental weighting while healthcare and higher education will have a greater weighting based on social factors). Several issuers in the market are utilizing green bonds, while some transportation credits have introduced climate initiative certified debt to our market.

While we have the capability to manage any of our Municipal Bond Strategies with client imposed restrictions, such as social guidelines, we also offer ESG focused Strategies for investors who prefer to invest in a socially conscious manner.

ESG factors have long played a part in our process. Our ESG specific portfolios have a more stringent threshold for high ESG scores, namely credits must score a 4 or a 5.

State GO's make up the largest percentage of your portfolio followed closely by investment in special tax and transportation bonds. What do you find most attractive about these sectors? What are you avoiding and why?

Mr. Moreland: Our active approach relies on buying and selling bonds. This requires our bonds to have greater liquidity and financial transparency than many smaller issuers within the market. We favor State GO's versus local GO's for these reasons. We avoid smaller issuers that do not issue debt often and therefore have less liquidity. Larger issuers need access to the capital markets and will provide more regular financial updates for analysts to assess their credit profile. Transportation and special tax bonds also align closely with the themes discussed above. We avoid some of the more esoteric issuers like nursing homes, land secured deals or any issuer that has a narrow and less reliable revenue stream.

Are there risks to the municipal bond market on the horizon that concern you? For example, is the possibility of an increase in inflation or a rise in interest rates a concern?

Mr. Moreland: Income is the greatest source of return for bond investors, so we welcome higher yields. We believe higher interest rates and the flexibility to take advantage of them will provide greater total returns for investors moving forward. Contrary to what most bond investors think, declining interest rates or low levels of rates are the biggest concern. Every bond will eventually mature, and if not managed properly, the investor will be forced to reinvest at even lower yields.

The opportunity of any bond investment is capped by its time to maturity. This is why bonds have less price volatility versus other asset classes. However, this window of opportunity closes more every day as the bond approaches par at maturity. It is in these windows of time where we can use our trading and research capabilities to great advantage to protect and grow our client's income and their capital.

President Biden's $1.9 trillion relief package just passed, with $350 billion designated for state and local governments. What impact do you think that will have on the municipal bond market?

Mr. Moreland: Similar to the CAREs Act and the December pandemic relief bill, this next round of stimulus will be very supportive of various segments of the municipal bond market, not just state and local credits. Prior to the COVID-19 pandemic, states had taken advantage of the past ten years of economic expansion to strengthen their balance sheets and build up record reserves. They were in a much better position to weather the economic effects of COVID-19 and assist their local governments. Over the past year, the states were quick to adjust their resources and cut budgets.

This next round of stimulus should be beneficial in boosting local economies and helping to stem the tide of public employment reductions and other important expense cuts. That said, not all parts of the municipal bond market will receive aid or the same amount of support. Muni-centric aid will be provided to higher education, mass transit and airports, to name a few. We are keenly focused on how each sector and issuer will be impacted by this new round of stimulus.

The COVID-19 pandemic has put a lot of pressure on state and local government budgets. How has that affected overall performance of the Strategy relative to the Bloomberg Barclays 5-Year Municipal Bond Index?

Mr. Moreland: Given the unprecedented selling pressure last year and credit spreads widening, our Strategy's higher quality bias helped overall performance during those periods of volatility. Subsequently, as the market rebounded and mutual funds saw a deluge of inflows, credit spreads tightened and that higher quality bias has hurt relative performance. With current credit spreads tighter than historical averages and the unknowns of the economic recovery that remain, we continue to focus on higher quality and the disciplined approach we take to fundamental research.

Do you anticipate municipal bonds will remain an attractive investment opportunity, given the fact that high-quality municipal bonds are no longer cheap relative to Treasuries?

Mr. Moreland: With the vaccine distribution accelerating and the prospect of the country opening back up soon, we have seen more pressure on Treasury yields rising in recent weeks. Municipal bond yields have been held in check for most of this year, largely because municipal bonds have been supported by less new issuance and stronger demand. This forced muni-Treasury ratios to richen to historic levels. However, we started to see an uptick in municipal bond yields in mid-February. It is difficult to predict new issuance in the upcoming months and all of the possible fiscal policy efforts within this new administration. Looking longer term, it is likely we will see higher taxes in some shape or form. The tax exemption of municipal bonds, therefore, should be more attractive for high-tax investors, and we should see healthy demand continue.

How will the possibility of an increase in corporate and personal income-tax rates benefit municipal bond investors?

Mr. Moreland: An increase in the federal personal income tax rates will have a direct benefit to tax-free municipal bonds. Quite simply, the higher the federal income tax rate, the more attractive tax-free municipal bonds become to individual investors in high tax brackets. An increase in corporate taxes could also benefit municipal bonds.

After the Tax Cuts and Jobs Act at the end of 2017, for example, we saw a decline in corporate tax rates which led to selling pressure by banks and insurance companies who were less incentivized to continue to own municipal bonds. Throughout 2018, we saw banks and insurance companies gradually unwind larger portions of their municipal bond holdings and look to taxable municipal bonds so they could maintain the diversification that municipal bonds provide. Looking forward, if we see an increase in corporate tax rates, it could result in renewed demand by those corporate entities.

What do you see ahead for municipal bonds, and in particular, the 2-8 Year Active Municipal Bond Strategy?

Mr. Moreland: The 2-8 Year Active Municipal Bond Strategy currently maintains a slightly shorter duration versus its benchmark. Typically, we have an allocation to "A" and below credits in the range of 10-15%, which is significantly lower than the Bloomberg Barclays 5-Year Municipal Bond Index range of 30-35%. Given its yield curve positioning and higher quality bias, we believe we are well positioned for investors looking to be more conservative.

If there is an increase in municipal bond market volatility, or if the yield curve steepens, we believe this Strategy should perform relatively well. Most importantly, the Strategy has plenty of flexibility to take advantage of higher yields and cheaper bonds for our clients. We are very optimistic.