MONTHLY REVIEW

February 2018

MAINLINE WEST

February 2018 Monthly Review - The MainLine Advantage Quantified

In 2018, munis continue to be weighed down by higher taxable rates and by a lack of new issuance which, paradoxically, creates a listless environment. However, they are one of the top performing fixed-income investments year-to-date, but have yet to show the price leadership we felt they would in 2018. It looks like it could stay this way in the near-term.

As a MainLine West investor, you have been purchasing bonds as efficiently as you can, in most cases, receiving the original offering price. This is providing you a much higher yield than most muni investors, according to a recent study. Fideres Partners LLP reviewed new issue pricing in various fixed income markets and, in doing so, has helped us quantify the "MainLine Advantage". *For a $10 million portfolio, this study would suggest our investors are earning $163,000 more per year in income than the average muni investor.*

Muni Market Review

Another month of interest rates creeping higher, lower than expected bond issuance, and lethargic trading in muni land keeps the year-to-date theme the same

We are still waiting for the muni market to get started in 2018. February market highlights are as follows:

- Muni yields increase from 11 to 15 bps with the curve staying unchanged.
- Taxable rates were up 14 to 16 bps and no change in the curve.
- Issuance is down 38% versus year-to-date 2017. New money issuance is virtually unchanged year over year, but refunding is down 74%.
- Muni to taxable ratios are showing munis to be at their richest level in some time.

Munis have been one of the top performing fixed income asset classes year-to-date. Returns are as follows:

ICE Data Index	2018 YTD Muni Outperformance
US Govt Master	+.654%
US Corp Master	+.932%
US Mortgages	+.400%

The technicals for munis over the next 30 to 60 days are seasonally week. It is hard to see munis really catch a strong bid over this time frame. Then again, we are still waiting for the stronger bid from a lower supply of bonds in 2018 and an increase in fund flows.

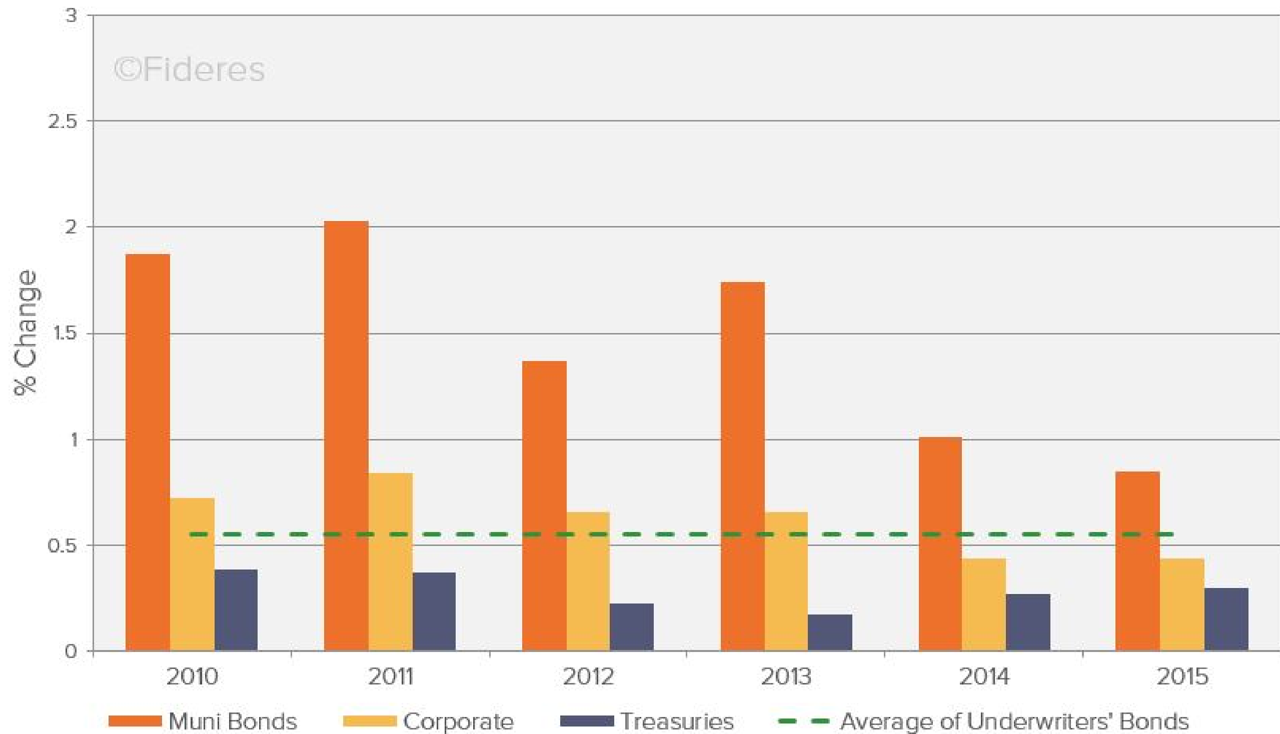
Market News and Credit Update

- A recent case in Illinois challenged the ability pf a P3 (public-private partnership) to file bankruptcy under Chapter 9, which is used for municipal issuers versus Chapter 11 by corporate issuers. The court ruled that a P3 municipal deal is not Chapter 9 eligible. This means the bankruptcy protection we like for revenue bonds does not exist for P3 deals and, therefore, needs to be priced and analyzed under a different set of criteria.
- The State of New Jersey, which already has the highest property tax in the nation, is seeing tax rates rise again. The average resident paid $8,690 in 2017, which is up 1.6% from the previous year. New Jersey's credit ratings are the lowest in the USA, next to Illinois at A- (S&P) and A3 (Moody's).
- Get ready Chicago! The City and its airline carriers are close to finalizing an $8.5 billion deal to expand O'Hare Airport. It would be an eight year plan to add on new gates, concourses, and a new "global terminal".
- A possible amendment to Dodd-Frank could improve muni-bond liquidity. A provision, to be voted on, would allow munis to be treated as "Level 2B" and high quality liquid assets by the banks. Although only 15% of munis outstanding are owned by banks, this change would improve demand, as it allows them to count their muni holdings into their liquidity calculation.

What is the MainLine Advantage?

We offer our clients "institutional pricing" and have, for years, have believed we are saving you money. We buy most of our customers bonds at issuance from the underwriter for the clearing price offered. By doing this, we avoid price market ups and additional broker commissions. ***A recent study from Fideres Partners LLP, a London based consulting firm, has put a value on this "savings".***

In the study, Fideres analyzed a Bloomberg sample of price increases from new bond deals from 2006 to 2015 for Municipal, Corporate and US Treasuries. The graph below shows the average percent change in price for each bond from its selling date to its settlement date.



Source: Bloomberg, Fideres

The graph shows us the following:

- *Muni bond prices on average increased 163 bps.*
- Corporate bond prices on average increased 64 bps.
- Treasury bond prices on average increased 33 bps.

Fideres goes on to conclude that these increases in bond prices after issuance shows that ***underwriters have underpriced bonds by the increase in basis points reflected***. For munis, they calculate this to be $28 billion from 2006 to 2015 (rough average of$2.8 billion a year). Then, they imply that this is the additional cost that the issuers are paying on their debt, therefore, costing the taxpayers money. This makes the muni market look very inefficient versus the other asset classes in the study.

Why do muni bonds look so inefficient? We feel we can explain and justify some of this "marking up" in prices:

1. The personality of the municipal market is not "streamlined":
   - It is small and regionally focused.
     - Average deal size of $35 million
     - Over 80,000 issuers
   - It is supported by the public, as over 72% of municipal bond investors are individuals buying bonds with a principal amount of $30,000.

2. The distribution of bonds starts at the "big bank" underwriter level, and then slowly gets disseminated out to the investing public. ***On the way, everyone trading and downsizing the deal is going to need to make money, and this comes from marking up the price on the bonds at each transaction.*** If you are going to have bond deals in sizes over $35 million, and final holding sizes of $30,000, you are going to have a lot of "price leakage" on the way.
3. There are also are costs associated with research and issuance that are unique to the municipal market. Those costs need to be allocated over a bond deal, that is paying a borrowing rate of at least 15% to 20% lower and a deal size 1/3 to 1/2 smaller in size than the other bonds in the study. This increases the "fixed cost" component of the deal and, therefore, the cost to support it.
4. Finally, the time length between pricing date and settlement date for munis is twice, sometimes three times as long as corporate bonds. This provides a lot more time for bonds to continue to trade up in price in the secondary market. Munis settle when-issued roughly 14 to 21 days from pricing. Corporate bonds settle in most cases 7 days or less.

That being said, we cannot defend the full $28 billion over 10 years, but we also argue that the benefits the municipal market provides the issuers, far out way its inefficiencies. The lower borrowing costs available to municipal issuers, the ability to control their own projects and costs, and the safety first investment quality available to its residents, provides a lot of good things in our minds.

At MainLine, we take out the "downsizing middleman", and we sell you the bond for the initial offering price. According to this study, we have saved our investors a potential 163 bps by doing this. For example your portfolio that is earning a 3.63% book yield, may be earning just 2.00% somewhere else. ***On a $10 million par value portfolio, this is providing an additional $163,000 in annual income.***

Now that's what we call the MainLine Advantage!

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