HOUSTON TRUST COMPANY

VIEWPOINTS

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Our Approach to Bond Investing

At Houston Trust Company, we manage our fixed income assets in-house by building custom-tailored, high-quality bond ladders to best fit our clients' needs. We recognize there are alternative methods of investing in bonds, such as through bond mutual funds; however we believe that constructing individual bond ladders offers the best solution for our clients. We further this discussion through the following points:

Bond mutual fund investors are subject to the fund outflows generated by other investors in the mutual fund.
When investors in the mutual fund sell, or redeem, their mutual fund shares; the mutual fund manager must deliver cash in exchange for the investors' shares. In periods of extreme market stress, many mutual fund managers may be forced to sell securities, held in the mutual fund, in the market in order to raise enough cash to meet investor redemptions. Oftentimes, these sales occur at inopportune times which result in losses to the net asset value (NAV) of the fund. An example of the above would be during the "Taper Tantrum" in the summer of 2013 when the market was concerned that the Fed would begin raising rates sooner than the market had originally anticipated. In response, outflows from bond mutual funds totaled $106 billion from June, 2013 to August, 2013[1]. Investors in bond mutual funds which are experiencing large redemptions must decide either to sell their shares at depressed prices, or hold their shares and hope to sell at higher prices in the future.

One advantage of owning individual bonds is reflected in the previous example. Even in times of market stress, the investor owning individual bonds has the flexibility to hold their bonds to maturity and receive the bonds' face value (also referred to as "par value"). The par value is known with certainty and is a contractual obligation to the issuer of the bond. Houston Trust Company favors the use of bond ladders, whereby we stagger the maturities of each bond in one's portfolio, creating a "natural" source of liquidity for the client as bonds are maturing at regular intervals in addition to the cash flow generated by the bond portfolio's interest payments.

Downtown Houston skyline from the southwest side panorama. 1927. Special Collections, University of Houston Libraries. University of Houston Digital Library. Web. December 18, 2016. http://digital.lib.uh.edu/collection/p15195coll2/item/210.

[1] Collins and Plantier, "Are Bond Mutual Fund Flows Destabilizing? Examining the Evidence from the "Taper Tantrum", Investment Company Institute, September 1, 2014

Bond mutual fund investors are subject to the capital gains realized by the mutual fund. When mutual fund managers sell bonds, either to meet investor redemptions or to reposition the underlying securities in the fund, the net realized gains are shared by all investors in the mutual fund on a pro rata basis. While the same tax rules apply to investors holding individual bonds, the investors who own individual bond ladders have total control over the net realized gains since they are not subject to these types of transactions from external sources. This aspect of control over individual bonds versus bond mutual funds is highly attractive for tax sensitive investors.

At Houston Trust Company, we take a buy-and-hold approach to bond investing which minimizes portfolio turnover along with any resulting negative tax ramifications. We do not engage in "total return" trading strategies within our clients' bond portfolios, and will generally only sell a bond position when we believe it is prudent to do so from a credit perspective.

Diversification is desirable, but up to a point. Mutual funds are highly diversified, often owning several hundred different bond issues within their fund. While this approach offers a high degree of issuer diversification, it can sometimes come at an expense. For example, a large portion of municipal bond mutual funds own Puerto Rico debt as part of their holdings since this issuer is exempt from both federal and state taxes. As a result of this advantageous tax treatment on Puerto Rico debt, more than 75% of municipal bond funds tracked by Morningstar own bonds issued by the Commonwealth of Puerto Rico[2].

We believe in building diversified, high quality bond ladders by incorporating a mix in both issuers and issuer source of funds (i.e. revenue and general obligation) when constructing bond ladders for our clients. We do not sacrifice credit quality for the sake of diversification, and we employ active credit monitoring for every bond position held by our clients.

The issue of municipal bond market liquidity and bid-ask spreads. Unlike equities which trade on an exchange, whereby there is a readily available market quoted price for the securities; municipal bonds trade in the over the counter (OTC) dealer markets. Thus, there is currently no readily available continuous market pricing mechanism available for investors in the municipal securities market. In 2004 and 2012, the SEC undertook several studies relating to the liquidity of the municipalmarket. According to their findings, "The unique municipal bonds that do trade, trade on average 1.5 times per year, according to the 2004 SEC *Report on Transactions in Municipal Securities (July 1, 2004)*." Furthermore, the SEC found that "about 99% of outstanding municipal securities did not trade on any given day, according to the 2012 SEC *Report on the Municipal Securities Market (July 31, 2012)*."[3] This relative illiquidity of municipal securities can be an issue for investors wishing to trade municipal bonds, especially during times of market stress (i.e. rate or credit shocks). Also, studies have shown that trade size affects bid-ask spreads for municipal bonds.

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[2] Schroders Talking Point, "What Happens in Puerto Rico may not Necessarily Stay in Puerto Rico", October, 2013

[3] Venditti, "Liquidity: The Hidden Risk in the Municipal Market", AAII Journal, January, 2015

The table below, taken from a recent Vanguard report[4], depicts the average transaction price impact (in terms of bid-ask spread) for various trade sizes. We can conclude from this report that there appears to be an inverse correlation between trade size and the size of the bid-ask spread.

Based on the average spread for municipal bonds during three days in August and September 2012

		Spreads in basis points			
Trade size	Number of trades	Price bid-ask spread	Spread relative to trade of more than $1 million	Yield bid-ask spread	Spread relative to trades of more than $1 million
More than $1 million	67	31	—	10	—
$100,000 to $1 million	381	64	+33	23	+13
$50,000 to $99,999	304	91	+60	33	+23
$0 to $49,999	1,774	171	+140	70	+60

Notes: The table shows an average of the bid-ask spreads incurred on August 1, August 14, and September 13, 2012. A basis point is 1/100 of a percentage point.
Sources: Vanguard Fixed Income Group and Municipal Securities Rulemaking Board.

Mutual funds carry the advantage of being able to conduct regular trading activities in large (+$1 million) block sizes, implying smaller round-trip trade costs when buying and selling municipal securities. However, there are a few points to consider before jumping to an immediate conclusion. First, bid-ask spreads are generally not static. They tend to widen in times market turmoil and contract when supply and demand are both high and coupled with low volatility. As mentioned above, municipal bond mutual fund investors are impacted by the actions of other investors within the same fund. In times of market stress, large mutual fund redemptions from the fund's investors may force the fund to sell securities to raise cash at inopportune times, generally reflected in wider than average bid-ask spreads[5].

A second point to consider when examining the table above is that a difference in execution quality exists between "retail" and "institutional" market participants. Most brokerage firms explicitly differentiate between their retail and institutional trading desks in order to best service the needs of these different types of accounts. Retail trades are generally smaller in size and carry larger bid-ask spreads versus their institutional counterparts. For example, one estimate from BNY Mellon places the average retail spread for bonds at 173 basis points compared to just 25 basis points for the average institutional spread.

At Houston Trust Company, we work with some of the largest regional institutional brokerage firms in order to obtain institutional-level pricing on all of our bond purchases and sells. We rigorously track execution quality in order to ensure best execution so that we can pass this observed pricing advantage along to our clients.

In summary, we believe that owning individual bonds offers compelling advantages over investing in bond mutual funds for our clients. Our rigorous process of pre-trade credit evaluation, continuous real-time credit monitoring and focus on execution quality enable us to build diversified, high quality bond ladders for our client portfolios in an efficient manner. At Houston Trust Company, we do not invest in proprietary investment products; which allows us to avoid any potential, or perceived, conflicts of interests when making investment decisions on behalf of our clients' best interests. Our approach to bond investing, as outlined above, is a result of this client centric focus that is firmly rooted in all aspects of our investment process.

4 Vanguard, "A Topic of Current Interest: Bonds or Bond Funds?", Vanguard Research, December 2012

5 Harvey, "Managed Municipal Accounts-Passing the Advantages of Institutional Executions Along to Individual Investors", Standish, March 2014