Executive Summary

- The municipal ("muni") bond market posted strong results but modestly lagged its taxable counterpart during the first quarter.
- As was the case with the taxable bond market, falling interest rates were supportive for muni market returns.
- From a sector perspective, an overweight and security selection to industrial revenue, along with security selection in education, water & sewer and transportation, contributed to performance. The Fund’s quality biases were also additive for returns.
- On the downside, having a shorter duration than that of the benchmark detracted from performance, as rates declined during the quarter.
- Western continues to see steady fundamentals in the overall municipal market due to a number of factors, including low unemployment, steady tax revenues and modest budgetary spending proposals.
- Adjusted for credit quality ratings, Western believes municipal bonds are attractive versus their taxable counterparts for maturities 10 years and greater.

Market overview

U.S. Treasuries generated a positive return during the first quarter of 2018, as did the spread sectors (non-U.S. Treasuries). Both short- and long-term U.S. Treasury yields declined during the quarter, driven by expectations for moderating global...
growth, benign inflation and “dovish pivots” by several central banks (yields and prices move in the opposite direction).

Looking at the U.S. economy, according to the Commerce Department, fourth-quarter 2018 gross domestic product (GDP)\(^1\) annualized growth was 2.2%. In contrast, the economy expanded 3.4% during the third quarter. Moderating growth in the fourth quarter was attributed to deceleration in private inventory investment, personal consumption expenditures (PCE) and federal government spending, along with a downturn in state and local government spending. These factors were partly offset by an upturn in exports and an acceleration in nonresidential fixed investment. Furthermore, imports increased less in the fourth quarter than in the third quarter of 2018. The initial estimate for first-quarter 2019 GDP is scheduled to be released on April 26.\(^2\)

After four increases in 2018, the Federal Reserve Board (“Fed”)\(^3\) kept its target rate unchanged in a range between 2.25% and 2.50% during the first quarter. At its January meeting the Fed said, “In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate ....” Then, at its March meeting, most Federal Open Market Committee members indicated that they did not feel additional rate hikes would be needed in 2019.\(^4\)

Both short-term and longer-term Treasury yields declined during the first quarter. When the period began, the yield on the two-year Treasury was 2.48%, and it ended the quarter at 2.27%. Its low for the period of 2.22% occurred on March 27, and it rose as high as 2.62%, on January 18. The yield on the 10-year Treasury began the year at 2.69% and it ended the quarter at 2.41%. Its low for the period of 2.39% occurred on March 27, and it rose as high as 2.79%, on January 18.\(^5\)

The municipal (“muni”) market posted strong results, but it modestly underperformed the overall taxable bond market during the first quarter. As was the case with taxable bond market, munis were supported by falling interest rates. All told, the Bloomberg Barclays Municipal Bond Index\(^6\) returned 2.90% during the first quarter, whereas the overall taxable bond market, as measured by the Bloomberg Barclays U.S. Aggregate Index,\(^7\) gained 2.94%.\(^8\)

**Contributors/detractors**

From a sector perspective, an overweight and security selection to industrial revenue, along with security selection in education, water & sewer and transportation, contributed to performance. The Fund’s quality biases were also additive for returns. In particular, overweights to securities rated BBB and below contributed to performance. On the downside, having a shorter duration than that of the benchmark detracted from performance, as rates declined during the quarter. From a sector positioning perspective, security selection in special tax negatively impacted returns.

During the quarter the Fund’s duration was slightly short to neutral versus that of the benchmark. Meanwhile, we maintained our overweights to muni securities rates A and BBB, and we continued to have a preference for revenue bonds over general obligation bonds.\(^9\) Given municipal investors’ desire for higher yields, we opportunistically sold credits where we felt valuations were stretched beyond the fundamentals.

**Outlook**

We continue to see steady fundamentals in the overall municipal market due to a number of factors, including low unemployment, steady tax revenues and modest budgetary spending proposals. Adjusted for credit quality ratings, we believe municipal bonds are attractive versus their taxable counterparts for maturities 10 years and greater. Looking ahead, we continue to favor revenue bonds over general obligation bonds.

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\(^1\) Gross domestic product (GDP) is the market value of all final goods and services produced within a country in a given period of time.

\(^2\) Source of data in this paragraph: Bloomberg, 3/19.

\(^3\) The Federal Reserve Board (“Fed”) is responsible for the formulation of policies designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.

\(^4\) Source of data in this paragraph: Bloomberg, 3/19.

\(^5\) Source of data in this paragraph: Bloomberg, 4/19.

\(^6\) The Bloomberg Barclays Municipal Bond Index is a market value-weighted index of investment-grade municipal bonds with maturities of one year or more.

\(^7\) The Bloomberg Barclays U.S. Aggregate Index is a broad-based bond index composed of government, corporate, mortgage- and asset-backed issues rated investment grade or higher and having at least one year to maturity.

\(^8\) Source of data in this paragraph: Bloomberg, 4/9.

\(^9\) A revenue bond is a municipal bond supported by the revenue from a specific project, such as a toll bridge, highway or local stadium.

\(^10\) A general obligation bond (“GO bond”) is a municipal bond backed by the credit and taxing power of the issuing jurisdiction rather than the revenue from a given project.
<table>
<thead>
<tr>
<th>Sector</th>
<th>Allocation (%)</th>
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</thead>
<tbody>
<tr>
<td>Industrial Revenue</td>
<td>25.3</td>
</tr>
<tr>
<td>Pre refunded / Escrowed to Maturity</td>
<td>13.9</td>
</tr>
<tr>
<td>Education</td>
<td>11.7</td>
</tr>
<tr>
<td>Transportation</td>
<td>11.2</td>
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<tr>
<td>Health Care</td>
<td>9.7</td>
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<tr>
<td>Water &amp; Sewer</td>
<td>6.5</td>
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<tr>
<td>Local</td>
<td>5.7</td>
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<tr>
<td>Special Tax Obligation</td>
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<tr>
<td>State</td>
<td>2.6</td>
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<tr>
<td>Housing</td>
<td>2.6</td>
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<tr>
<td>Lease Backed</td>
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<tr>
<td>Other</td>
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<tr>
<td>Solid Waste/Res Recovery</td>
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<tr>
<td>Power</td>
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<td>Government</td>
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<tr>
<td>Cash &amp; Cash Equivalents</td>
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</tr>
</tbody>
</table>

Percentages are based on total portfolio as of quarter end and are subject to change at any time. For informational purposes only and not to be considered a recommendation to purchase or sell any security.
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- Over a century of experience in identifying opportunities and delivering astute investment solutions to clients

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Please note, the Fund itself has not been rated by an independent rating agency.

U.S. Treasuries are direct debt obligations issued and backed by the “full faith and credit” of the U.S. government. The U.S. government guarantees the principal and interest payments on U.S. Treasuries when the securities are held to maturity.

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