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Charles W. Fish

Chairman and Chief Investment Officer

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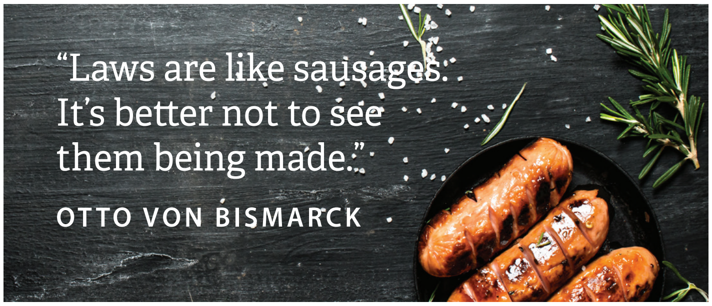
Letter from the Chairman…



Our new tax law changes the landscape for municipal bond investors in numerous ways. I'll try to point out the changes that will have the greatest impact on our clients.

First is the fact that municipal bonds will become ever more valuable to our clients, especially those residing in California. A slightly lower federal tax bracket is completely overshadowed by the $10,000 cap on the deductibility of SALTS (State and Local Taxes). The cap includes property taxes and most wealthy residents pay more than $10,000 on that one tax alone.

If you run the numbers (37% federal + 3.8% Affordable Care Act + up to 13.3% state) a corporate bond or C.D. with a nominal yield of 4% will only produce a 1.84% return after-tax. A municipal bond however, exempt from federal, state and ACA taxes, that you purchased at 4% will yield 4%. Under the new tax law the corporate bond would require a gross yield of 8.71% to give you 4% after taxes.

The supply of new issue municipal bonds will decline dramatically (estimates range from 20% to 30%) because of this law's prohibition on tax exempt advanced refundings. Current refundings are fine, but because any advance refunding will now have to be done with taxable bonds, the net savings to the issuer will be reduced to an extent that, in most cases, won't justify the endeavor. We should expect to see creative new language in bond documents with regards to call options.

Shrinking municipal supply works against our efforts to raise portfolio yields, but the competition for tax exempts should also be reduced. Corporations, and especially commercial banks, will enjoy a dramatic reduction in their tax rate to only 21%, rendering tax-exempt investments far less attractive. Besides general market municipals, banks in the past have been significant buyers of private placement issues, most of which will need to attract new investors.The desperate need for more infrastructure financing will hopefully ease the supply drought.

To pass this bill with a simple majority vote it had to comply with the Byrd Rule. That is to say it can't add to the federal deficit after its first decade in place. That's why the tax cuts for individuals have sunset provisions. The huge cut in the corporate tax rate, it is hoped, will stimulate the economy such that the revenues will soar and the red ink will go away. The problem with this projection is that, relatively speaking, corporations are awash in cash and have never been able to borrow more cheaply. If a company had an incentive to expand and hire more employees, wouldn't they have done it by now? It seems far more likely that companies will use their new wealth for mergers and acquisitions, dividends and stock buy backs - not for investing in new plants and equipment.

Going further into debt to fund capital projects like a super efficient power grid, energy farms, education and the like makes all kinds of sense. This settled law is different, however, more speculative and we must be patient before passing judgment. The question is, should it fail, and instead produce a massive increase in the federal deficit, what then is plan B? What must be cut that will bring our budget back into balance? And how might such cuts impair future growth?