

## Is bigger always better?

## Potential advantages of utilizing a boutique approach to municipal SMAs

### About Federated Hermes CW Henderson

Specialist in municipal separately managed accounts (SMA) for high-net-worth and institutional investors

Founded in 1990

\$4.12B in AUM\*

1,687 client accounts\*

**Strategies:** Intermediate and Ultrashort

**Customization:** State specific, state preference, duration and maturity

**Key investment team:**

Craig Henderson, CPA, Matt Andrews,  
David Beck, Monika Bhasin,  
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\*As of 6/30/24

### Overview

While some managers may employ a more passive, laissez-faire approach to municipal bond SMA management, Federated Hermes CW Henderson (CWH) employs a highly selective, hands-on process for client portfolios and service.

Our points of differentiation include:

**Portfolio structure:** We focus on the highest quality bonds (AAA and AA rated) with a barbell approach to portfolio construction, based on our belief that clients value liquidity and utilize municipal bond SMAs for the conservative, low risk component of their asset allocation. Accounts are customizable based on state preference and/or duration and maturity guidelines.

**Security selection:** We are highly selective about the securities we purchase in pursuit of the best value for our clients. We seek to add value through trade execution, discernment, and active positioning of duration. We take a client-centric approach to portfolio construction and consider state of residence in our evaluation of appropriate securities.

**Proactive tax-loss harvesting:** Our proprietary approach to actively harvesting losses throughout the year allows us the opportunity to capitalize on short-term volatility while keeping accounts fully invested. Harvested losses can be used to offset realized gains in other investments or carried forward indefinitely.

**Client service:** Senior level portfolio managers are readily accessible for client conversations. We seek to cultivate deep relationships with clients, taking time to understand risk tolerances and investment objectives.

## Portfolio structure: Designed for wealth preservation and income generation

We view our municipal bond portfolios as the conservative, low risk component of our investors' portfolios. We strive to maintain very high credit quality in client portfolios by primarily investing in bonds rated AAA and AA, with the goal of mitigating credit risk and lessening the potential adverse impact from credit spread widening that often occurs in lower-quality issuers.

In contrast to laddered strategies, our "barbell" approach has the potential to generate a higher rate of return versus a comparably rated ladder and the opportunity to actively manage duration exposure. With approximately 50% of the portfolio allocated to short and ultrashort duration securities, portfolios maintain a high level of liquidity throughout all market environments. Clients with frequent cash flow requirements may prefer this type of structure to a ladder strategy.

The barbell construction we employ consists of:

**High coupon/short call bonds** for greater price stability and the potential for enhanced returns if the bonds do not get called.

**Ultra-short, non-callable allocations** to take advantage of the strong demand for eligible securities by tax-exempt money market funds.

**High coupon/intermediate callable bonds and 10 to 15-year securities, with 9 and 10-year call features**, which take advantage of a positively sloped yield curve to seek capital appreciation in declining rate environments.

## Why we invest in premium bonds

Many investors prefer purchasing bonds at a discount or near par or \$100. Par bonds are simple to understand and easy to explain. What most investors do not realize is that par-type bonds are subject to a potentially very costly risk known as de minimis risk.

A little-known aspect of the Revenue Reconciliation Act of 1993, the de minimis rule negatively impacts municipal prices when interest rates rise. While investors may be drawn to the higher yields on discount or par bonds, they should understand the potential for higher volatility because of the de minimis rule. Based on the rule, investors are subject to ordinary income taxes on the price appreciation of discount municipals if bonds are purchased below de minimis thresholds. A bond's downside price volatility is increased as the de minimis level is breached due to the ordinary income tax impact. Liquidity of lower coupon bonds originally purchased at par also lessens dramatically when rates move higher. After all, who wants to own 2% and 3% coupon bonds when the market is readily issuing 5% coupon bonds?

If an investor is concerned about liquidity and price volatility, de minimis risk should be minimized by favoring premium bonds trading at prices that are several points above de minimis levels. Higher coupon, premium bonds are characteristically more defensive in nature than lower coupon bonds. Premium bonds can limit portfolio volatility and provide protection against de minimis risk, negative convexity risk (larger price declines than price increases when interest rates fall by an equal amount), and duration extension risk.

## Security selection

CWH endeavors to operate with greater agility and flexibility compared to larger firms. We look to swiftly adapt to market changes and navigate volatile environments more effectively. In our view, larger firms are typically less tactical because strategies to manage through and capitalize on short-term market volatility can be difficult to scale across a very large investor base. It is simply much easier to adjust duration and portfolio structure when managing \$4-\$8 billion, compared to \$40-\$80 billion. Additionally, we are generally able to have portfolios invested in 4-6 weeks.

We deploy several strategies to add value in portfolios:

- **Relative value trading:** We believe we can be more discerning in terms of security selection compared to larger peers
- **Purchasing matching blocks:** By purchasing smaller, matching blocks of already owned securities, an exercise often overlooked by larger peers, we have the potential to add significant incremental yield
- **Electronic trading programs:** Potential for more attractive pricing relative to traditional dealers
- **Tailored security selection:** Individual client circumstances such as state of residence are central to our decision making at the account level

## Case study: Discernment

We are not "price takers" – there is no pressure to purchase deals that are not as attractively priced to facilitate keeping accounts fully invested. If two like issuers (similar maturity and credit risk profile) come to market and one deal is priced several basis points cheaper, we can be selective and only purchase the more attractively priced deal.

For example, two School Fund deals were priced the same day (5/14/2024) with similar credit quality and maturity profiles as shown in the table. We passed on the School Fund Bond A deal and purchased the School Fund Bond B deal which was more attractively priced. This incremental yield pickup may not seem large on the surface, but this discernment and selectivity in each transaction has the potential to enhance total return over time with the effects of compounding.

	Passed	Purchased
<b>Issuer</b>	School Bond Fund A	School Bond Fund B
<b>Maturity</b>	8/15/2039	8/1/2039
<b>Credit Rating*</b>	AAA (Enhancement) A+ (Underlying)	AAA (Enhancement) A+ (Underlying)
<b>Coupon</b>	5.00%	5.00%
<b>Price on 5/14/2024</b>	\$112.96	\$113.71
<b>Yield to Worst</b>	3.35%	3.39%

This example is illustrative of the investment process and not an investment recommendation.

## Customization

All CWH strategies are fully customizable to state of residency for taxation purposes, duration, quality and/or sector restrictions, and the potential need for income distributions.

We can construct state specific portfolios, for states with significant issuance such as California and New York, and state preference portfolios for states where there is a tax benefit to owning in-state securities, but the resident state has a lower tax rate and is a lesser issuer of bonds (Colorado, Ohio, Pennsylvania, etc.).

In CWH national client portfolios we are much more tailored and focus our efforts on allocating high quality securities from non-specialty states to client accounts – Florida, Nevada, Texas, Tennessee, Washington, etc. – and attempt to avoid specialty state issuers, or states with high income tax rates, often dramatically increasing yield opportunities versus larger peer approaches.

Notably, when we inherit bonds from clients in locations where there is no state income tax, one of the biggest pitfalls we see in these national portfolios is significant exposure to specialty state bonds. Specialty state securities provide geographic diversification, but due to the demand for in-state bonds from residents, yields on these bonds tend to be lower than on bonds issued in states with low or no taxes ("non-specialty states"). Overexposure to specialty state bonds is a common mistake that can have a material adverse effect on yield expectations in portfolios.

### Proactive tax-loss harvesting

Short-term market volatility creates valuable opportunities to harvest losses throughout the year, but most investors don't contemplate loss harvesting until the fourth quarter. In addition to missing opportunities earlier in the year, dealers anticipate heightened loss harvesting activity toward year-end and adjust their pricing in response.

CWH takes a proactive approach to harvesting tax losses in client accounts – we do not wait for client requests. We monitor gains and losses on a continuous basis, starting in early January, and will harvest

tax losses throughout the year when we believe advantageous trades can be executed.

Our size often allows us to execute swap trades between client accounts, rather than transacting in the secondary market, potentially improving the efficiency of the tax-loss harvesting process. Losses are immediately harvested, clients remain fully invested and account level characteristics (quality, duration, yield, etc.) remain largely unchanged.

### Tax-loss harvesting process:

Identify swaps across client accounts >> execute swaps to immediately harvest losses >> investors recognize losses and remain fully invested.

### Hypothetical bond swap for loss harvesting

Market values based on a \$2,000,000 portfolio

Account	Issuer	Market value	Maturity date	Coupon	Purchase price	Yield to worst	Price after 50 basis point rate increase*	Yield to worst (Post rate move*)	Market value after 50 basis point rate increase	Unrealized loss - recognized for TLH	Loss harvesting value (% of total portfolio)
Client A	Muni Bond A	\$115,079.00	2/15/2036	5%	\$115.08	3.03%	\$111.00	3.53%	\$111,002.00	\$(4,077.0)	0.20%
Client B	Muni Bond B	\$115,999.00	2/15/2036	5%	\$116.00	2.92%	\$111.88	3.42%	\$111,883.00	\$(4,116.0)	0.21%

\*Assumes an instantaneous 50 basis point rate shock.

For illustrative purposes only, not to be deemed a recommendation for a specific security or sector.

### Client service culture

We believe our highly proactive investment approach goes hand-in-hand with personalized service tailored to the unique needs and preferences of each client. Senior level portfolio managers are readily accessible for portfolio consultations and client conversations. We cultivate deeper relationships with clients, taking time to understand risk tolerances and investment objectives.

### Risk Considerations

High-yield, lower-rated securities generally entail greater market, credit/default and liquidity risks, and may be more volatile than investment grade securities.

Bond credit ratings measure the risk that a security will default. Credit ratings of A or better are considered to be high credit quality; credit ratings of BBB are good credit quality and the lowest category of investment grade; credit ratings of BB and below are lower-rated securities; and credit ratings of CCC or below have high default risk. Bond prices are sensitive to changes in interest rates, and a rise in interest rates can cause a decline in their prices.

This should not be construed as a recommendation regarding tax information.

Consult your tax professional for more information.

Separately managed account portfolios strategies are only offered to certain qualified investors.

There is no guarantee that any specific investment approach will be successful.

The amount of public information available about municipal securities is generally less than that for corporate bonds. Special factors, such as legislative changes and local and business developments, may adversely affect the yield or value of municipal securities.

Credit ratings do not remove market risk.

Income from municipal securities may be subject to the federal alternative minimum tax and state and local taxes.

Bond prices are sensitive to changes in interest rates and a rise in interest rates can cause a decline in their prices.

Investing involves risk, including possible loss of principal.

### Definitions

**Duration** is a measure of a security's price sensitivity to changes in interest rates. Securities with longer durations are more sensitive to changes in interest rates than securities of shorter durations.

**Yield curve** is a graph showing the comparative yields of securities in a particular class according to maturity. Securities on the long end of the yield curve have longer maturities.

**Yield to Worst (YTW):** On a corporate bond, the yield to worst is the lowest yield that a buyer can expect among the reasonable alternatives, such as yield to maturity, yield to call, and yield to refunding.

**Coupon:** The annual rate of interest on a bond's face value that the bond's issuer promises to pay the bondholder.

**Past performance is no guarantee of future results.**

**Not FDIC Insured • May Lose Value • No Bank Guarantee**