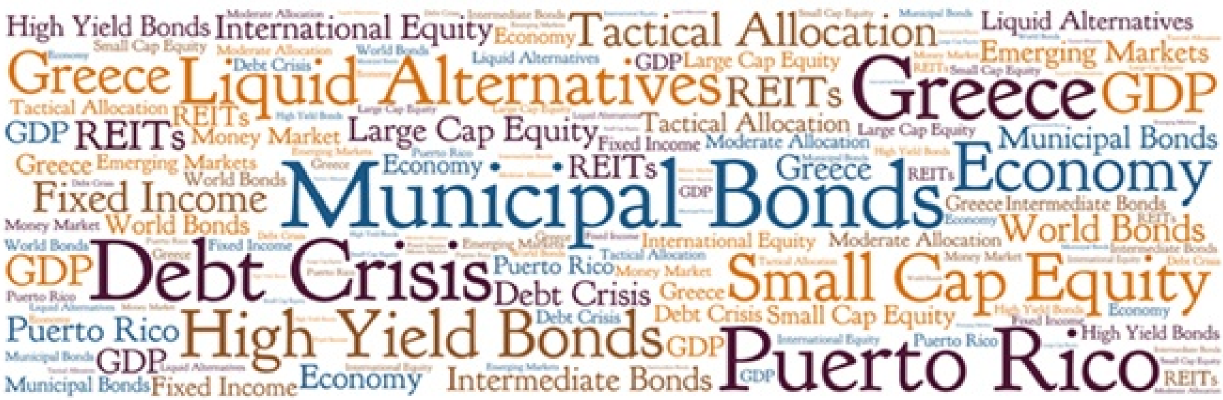


Fragasso Portfolio Perspectives - July 2015

Market insights from our portfolio management team

Welcome to our portfolio management team's inaugural monthly newsletter, Fragasso Portfolio Perspectives. Our industry analysts within the Portfolio Management Department at Fragasso Financial Advisors are excited about our new monthly newsletter because it is an opportunity for our team to zero in on timely market news events, how it may impact portfolios and what it means to your financial goals.

In this issue, Lisa Brignoni, CFA, AIF®, director of portfolio management, discusses municipal bonds, Puerto Rico and the importance of navigating this once dull, now interesting portion of fixed-income markets. When one steps back and assesses the situation, it becomes apparent that there is more to this market than mere bond yield.

Inside the Municipal Bonds Markets

Municipal or “muni” bonds, as industry insiders call them, do not attract quite as much investor attention as the latest IPO touting the newest “must-have” consumer gadget. However, when one considers the far reaching impact of muni bonds and the attractive features they offer to specific investors, muni bonds can invite some intrigue. As a simple characterization, muni bonds are debt obligations of state and local governments and generally come in two main flavors – general obligation and revenue bonds. General obligation bonds are paid from a government’s taxes and revenue bonds are paid from revenue-producing facilities.

These investments don’t sound exciting until you think about some of the wonderful things that muni bonds fund. This brings me all the way back to my first experience with muni bonds when I was in high school. Of course I did not know it at the time, but during high school my hometown was in the midst of some high-octane municipal bond action. Our local government proposed issuing more debt to fund a brand new high school for us students, a decision that was left to a vote. I remember all of the anticipation of the voting results, with my friends and myself more concerned about having a new gym with a swimming pool and bigger lockers than the ramifications for school taxes and traffic-flow patterns. The adults ultimately granted us our wish and a new high school was built in short order. Though I never did look back to review the financial results of this situation, I imagine all happened according to plan as far as the municipal bond side of this equation was concerned. So perhaps this wasn't the most exciting story ever, but I now appreciate the municipal bond asset class even though it has an unfair reputation for being boring. What is certainly not boring at this current point in time however is the current debt crisis simmering to a boil in Puerto Rico.

Puerto Rico is USA's Greece

When most of us think of Puerto Rico, images of tropical beaches, lush rain forests and perhaps colonial Spanish architecture, if you're intimately familiar with Old San Juan, spring to mind. However, this inviting image of a vacation paradise couldn't be further from reality when one considers the current debt crisis facing this island commonwealth. Not dissimilar from Greece though with its own unique challenges, Puerto Rico is currently caught in a cycle of borrowing, slow economic growth, austerity measures to pay off increasing debt and further economic deterioration as a result. Like Greece, Puerto Rico's local government now has the monumental task of resolving its debt situation and steering the commonwealth back towards economic growth.

Puerto Rico's current debt bill stands at roughly $72 billion, which represents almost 70 percent of its total GDP.[1] It's fair to say that a number of contributing factors resulted in the situation we see today. One notable factor was Puerto Rico's ease of issuing debt due to its favorable triple tax exemption. As a commonwealth, municipal bonds from Puerto Rico are exempt from federal, state and local taxes, a unique status not held by any other sector of municipal bonds. This feature increased the marketability of these bonds and allowed Puerto Rico to borrow excessively over long periods of time. Along with other economic factors that helped dampen Puerto Rico's ability to pay these bonds, we now see the island facing possible default.

Like his counterpart in Greece, Governor Alejandro García Padilla is feverishly working to cut a deal with the island's creditors to restructure the debt into more favorable terms. His stance is that there are no more measures to be made from a political and economic standpoint to pay these debts and they need a concession from creditors to have a decent shot at economic growth. After Padilla warned that the "debt is not payable," bonds dropped to record lows. Because of Puerto Rico's status as a commonwealth, default and bankruptcy claims are more complex and will take a significant period of time to sort out. This will no doubt have an impact on the municipal bond market as there is currently no precedent for this situation and borrowing costs for other municipalities are likely to rise.

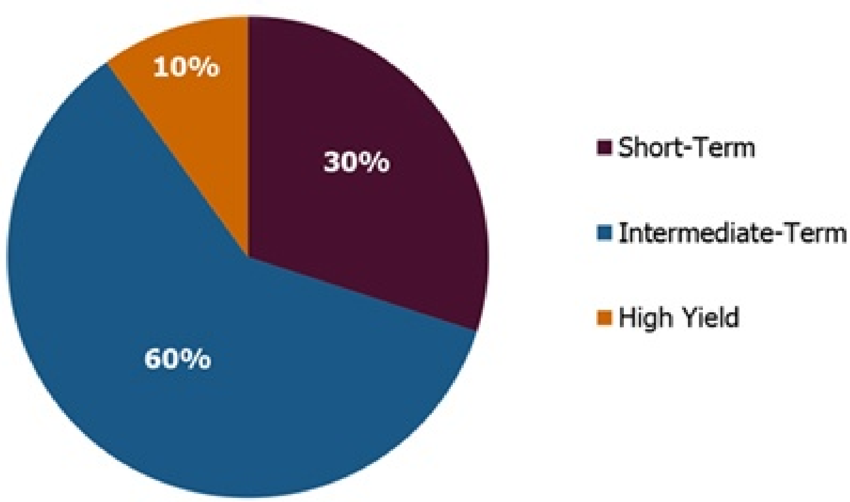
Current Fragasso Portfolio Positioning

Like all individual investments, municipal bonds are not suited for all investors and need to be carefully evaluated by an investment professional to determine if including them in a portfolio will serve an investor's best interests. Due to the exemption of interest income from federal taxes and sometimes state taxes, municipal bonds or bond funds are best suited for clients that are in very high tax brackets. At Fragasso, we offer these types of clients a tax-advantaged, fixed-income portfolio that is managed full-time and seeks to optimize returns in a tax-efficient manner.

As we consider the challenges facing the overall bond market with slowly rising interest rates and specifically, the muni bond market with the Puerto Rican debt crisis, we have positioned the tax-advantaged, fixed-income portfolio to mitigate the risks from both of these situations. The intermediate bond space is treated as a core and provides guardrails around our investment strategy, yet the flexible mandates of the managers we use allows the ability to take advantage of shorter durations, which will protect the portfolio in a rising interest rate environment. We have recently moved out of an alternative fund position that was not presenting positive opportunities given our market expectations and the fundamentals of the fund. We have reallocated this position to the intermediate and short-term sectors to further protect against rising interest rates. We also continue to monitor other potential investments for a future tactical change that may capture outperformance.

Though we do allocate 10 percent of the fixed-income portfolio to high-yield bonds as part of a well-rounded diversified portfolio, in this particular asset class, we have selected a more conservative manager. This high-yield manager is also considered to be more strategic in nature, meaning that its mandate allows it to seek outperformance in other sectors providing greater flexibility and an opportunity to generate alpha. Though a ripple effect throughout the municipal bond market is expected if Puerto Rico defaults, we believe the risk within this portfolio is limited and the positioning is appropriate to weather a volatile environment over the long run.

Current Tax-Advantaged Fixed-Income Allocation



If you think that a municipal bond portfolio strategy makes sense for you, please feel free to reach out to one of our advisors to see how we can help you achieve your financial goals.

1 - Kuriloff, Aaron. (2015, June 29). Puerto Rico Urges Concessions From Creditors. Wall Street Journal. Retrieved from http://www.wsj.com/articles/puerto-rico-releases-report-calling-for-concessions-from-creditors-1435588154.