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Investment Management

California Intermediate Municipal Bond Portfolio

Second Quarter 2018

Market Review

Tax-exempt municipal bonds broadly outperformed comparable taxable asset classes in the second quarter and year to date.

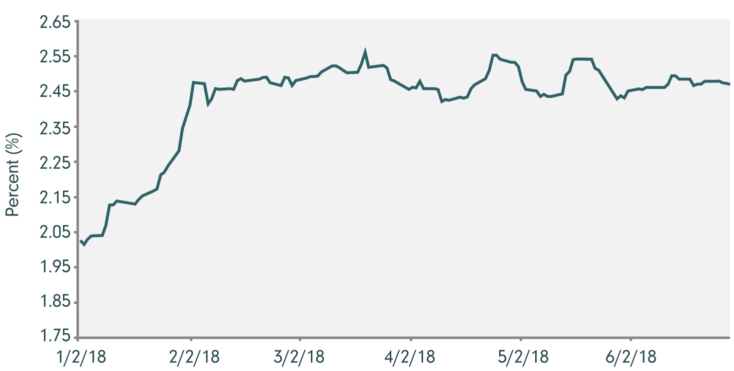
The Bloomberg Barclays 5-Year Municipal Bond Index was up 0.87% for the quarter, more than offsetting first-quarter losses for a 0.30% gain year to date.

That compares the Bloomberg Barclays U.S. Aggregate Bond Index, which posted another down quarter, -0.16%, for a year-to-date performance of -1.62%. The Bloomberg Barclays U.S. Government/Credit Index was essentially flat for the quarter, with a 0.01% gain that brought the first-half return to -0.97%.

The 10-year U.S. Treasury yield closed the quarter at 2.86% after a volatile quarter, up from 2.74% as of March 31. It rose during the first half of May, hitting 3.11% in the middle of the month, the highest level since 2011. This trend reversed as political turmoil in Italy and continued U.S. trade rhetoric contributed to a rally toward safe-haven assets, such as U.S. government debt.

The yield on the 10-year municipal bonds benchmark fluctuated throughout the past three months and ended the quarter little changed, at 2.47%. The rate saw a bump at the beginning of this year and has stayed more or less sideways.

10Y Muni Benchmark Yields 1H18



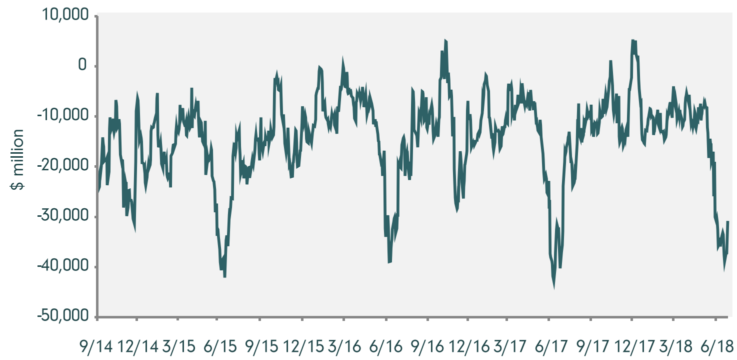
Source: Bloomberg

Net Negative Supply

Supply remains an issue in the muni world, a continuation from the first quarter when much of advanced-refunding issuance planned for 2018 had moved up to December 2017 in a rush to beat the new tax bill, creating a void.

A recent review of muni calls and maturities against new supply shows a notable decline in net muni supply nationwide through the month of June.

Net National Supply



Source: Bloomberg, data through June 29, 2018

Net supply is highly seasonal, as seen in the regular dips in the summer months. In addition to seasonality, market factors accounting for the supply dip and potential near-term challenges include the following:

- Not only does research show that the universe of bonds eligible for refunding has shrunk, but the new tax law's elimination of the tax exemption on advanced-refunding bonds also helped lead to a smaller market. Plus, bonds that were to have been issued would have been moved up to the end of last year to beat the implementation of the tax bill.

- The lack of federal support geared toward infrastructure improvements also impacted the level of bond issuance. In addition, states continue to be pressured by pension obligations. Some, such as California, have assigned more money from the state budget to go toward pension funds to make up for projected lower returns. This could be seen as money moving away from potential infrastructure investment.

Beyond the summer, gross issuance for the whole year is estimated to reach $335 billion, with net issuance of -$125 billion, according to Citibank. About 43% of the total gross supply had been reached in June.

Demand Coming from Abroad, High-Cost States

Data point to strong demand for municipal bonds coming from foreign investors. By the start of 2018, overseas investors owned $100.5 billion worth of U.S. municipal debt, a record level and about twice the figure a decade earlier, according to Federal Reserve data.

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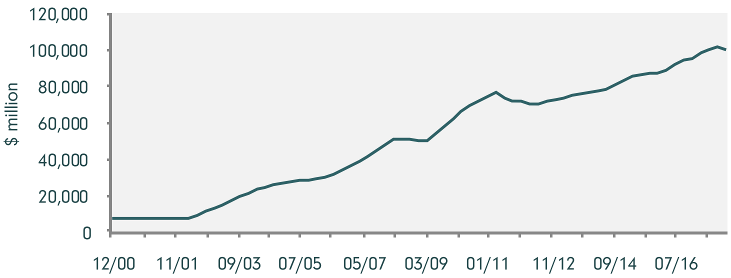
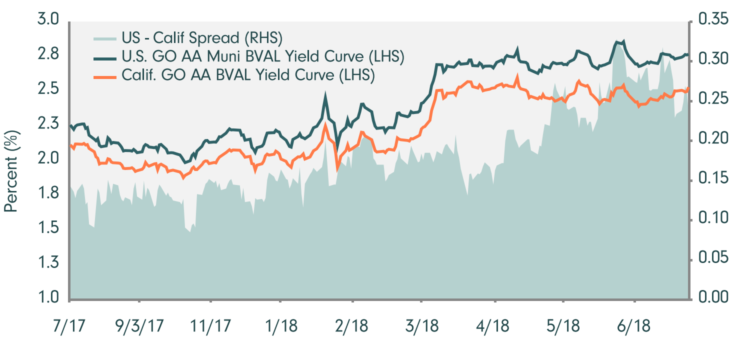
Foreign Holdings of U.S. Municipal Securities



Source: Federal Reserve Economic Data, data through Jan. 1, 2018, latest available on FRED

In addition, the new $10,000 cap on SALT deductions introduced as part of the tax reform has led to increasing demand from residents of higher-cost states for the tax-advantaged bonds. Anecdotal narratives point to growing demand from individual investors in California, which could be a key factor behind the falling yields on the state bonds. The graph below shows the yield pricing on California's general obligation bonds consistently falls below the nationwide comparison, with the difference between the two rates widening significantly over the second quarter.

U.S. vs California General Obligation Bond Yields



Source: Bloomberg, data through June 29, 2018

The current story of supply and demand appears clear: Record levels of demand from foreign investors and growing interest from states due to the greater appeal of tax advantages, coupled with dampened supply owing to seasonality and market factors keeping a lid over new issuance. How this dynamic develops over the course of the third quarter will bear watching.

Potential for Strengthening of Credits

The Supreme Court in June closed a loophole that had allowed internet sales, for the most part, to be tax free. The recent decision now allows states and local governments to require internet retailers to collect sales taxes, a win for brick-and-mortar businesses that have felt disadvantaged and for localities that have struggled with slow growth in tax revenue.

Estimates indicate state and local governments could collect an extra $8 billion to $23 billion a year following this rule. This could boost muni bonds backed by sales-tax revenue and can help boost credits.

Portfolio Review

The KAR California Intermediate Municipal Bond Portfolio slightly underperformed the Bloomberg Barclays 5-Year Municipal Bond Index for the second quarter.

The highest-performing municipal bonds during the quarter were in the triple-B rated sector, as investors reached lower into the rating barrel to find yield. Other sectors with higher performance were the traditionally volatile hospital and housing sectors. We avoid all of these, focusing instead on high-quality bonds in sectors with lower volatility. While owning a lower-rated health care bond would have performed well these past three months, we prefer not to be invested in those sectors.

Demand for tax-advantaged securities is expected to remain high, while a technical imbalance could continue to strain supply. We believe our ability to identify opportunistic trades in individual bonds remains a key advantage. We will continue to focus on quality municipal debt with ballast-like characteristics that serve to anchor a diversified portfolio.