



Looking Beyond Yield: 4 Muni Drivers

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Presented By



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Meet the expert



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Today's discussion

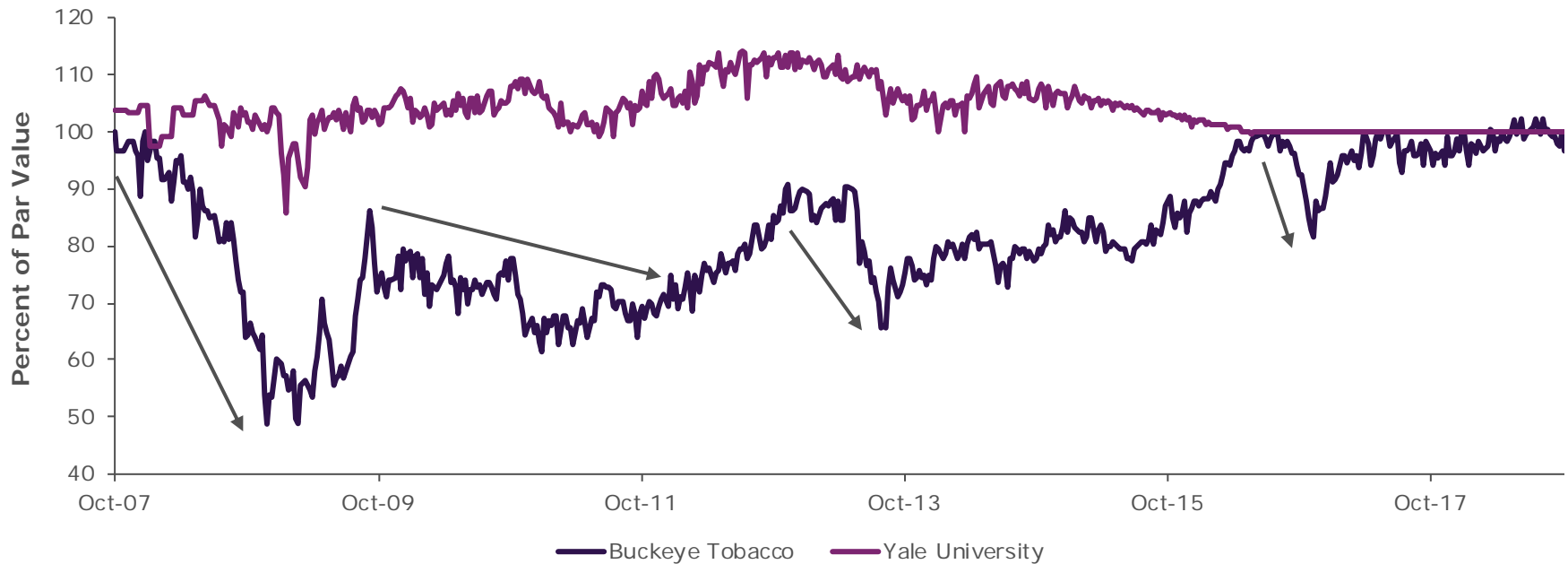
- Managing for total return versus yield-first
- Defining the four drivers of portfolio management
- Why each is critical to evaluation
- Key takeaways and next steps

Four drivers of alpha within a muni portfolio



The potential risk of a yield-first focus

Higher yields have been historically-offset by negative price returns



Buckeye Tobacco Settlement Bonds

- Issued: 10/29/2007
- Maturity: 6/01/2047
- Coupon: 5.875%
- Yield at Issuance: 6.070%

Yale University Bonds

- Issued: 10/04/2007
- Maturity: 07/01/2042
- Coupon: 5.00%
- Yield at Issuance: 4.5%

As of 9/30/2017 the Buckeye Tobacco and Yale University Bonds were not holdings in any of the Wells Fargo Funds that the WFAM Municipal Team manages. The example above is being shown for illustrative purposes only.

Investing for income-only historically has carried risk

Credit fundamentals matter along with yield and tax status



Puerto Rico Commonwealth

- Issued: 3/17/2014
- Maturity: 7/1/2035
- Coupon: 8.00%
- Yield at Issuance: 8.727%

As of 9/30/2017 the Buckeye Tobacco and Yale University Bonds were not holdings in any of the Wells Fargo Funds that the WFAM Municipal Team manages. The example above is being shown for illustrative purposes only.

Source: Bloomberg. As of 10/31/2018.

Managing for total return

- Investors often use fixed income for the more conservative portion of their portfolio
- Managing for total return offers a less volatile investing experience
- We look to participate in strong markets and provide downside protection in weak markets



Driver #1: Active duration management

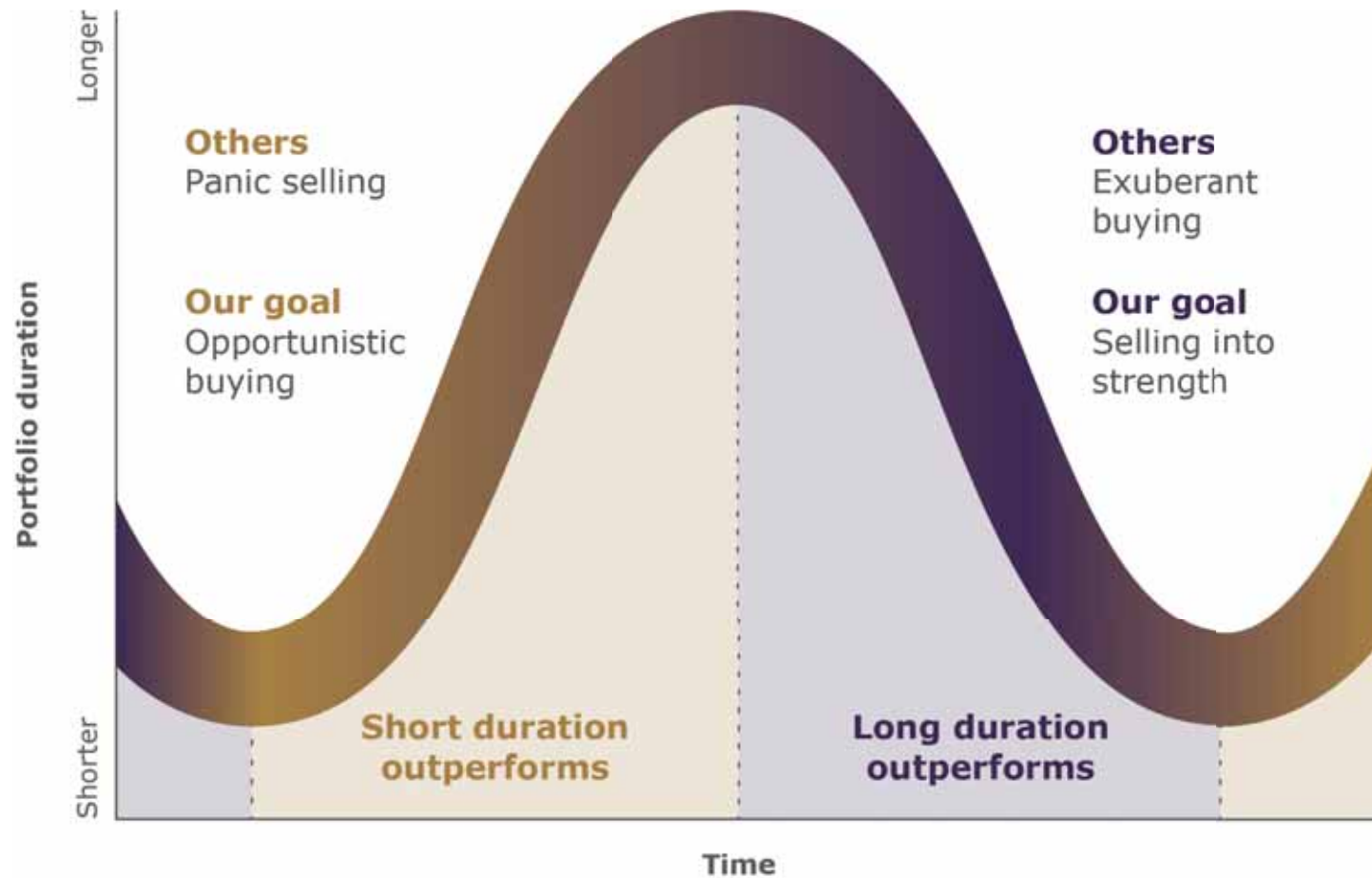


Duration

- Duration measures the interest-rate sensitivity of a bond or bond portfolio.
- The longer a portfolio's duration, the more sensitive it is to changes in market yields.

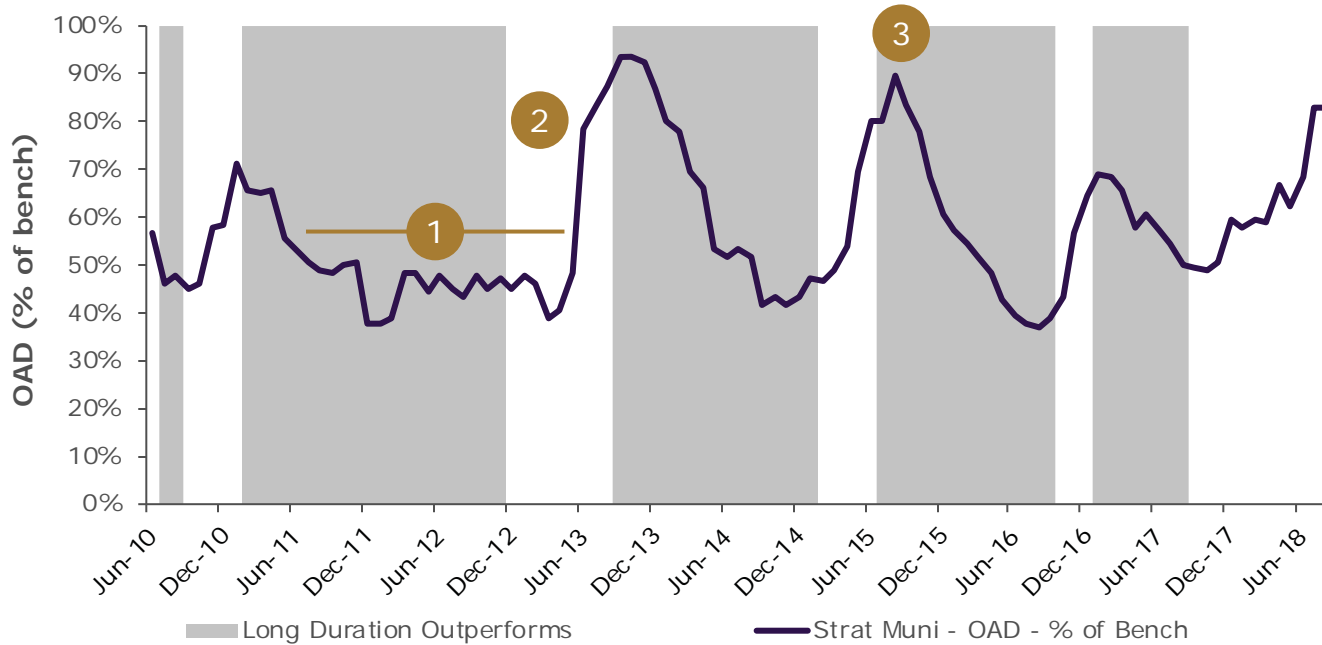
Active duration management

Lengthen and shorten duration opportunistically



Active duration management

Take advantage of market opportunities



Wells Fargo Strategic Municipal Bond Fund's effective duration to its benchmark, the Bloomberg Barclays Short-Intermediate Municipal Bond Index

- 1 Maintain the fund's duration at less than half the benchmark's duration.
- 2 Extend duration at compelling valuations (buy low).
- 3 Lock in gains among longer-duration holdings (sell high).

How to apply it



Duration

- Lengthen portfolio duration in advance of a duration rally.
- When others engage in panic selling of duration, buy it.
- When exuberant buying reduces relative-value opportunities, sell into strength and shorten portfolio duration.

Driver #2: Yield-curve positioning

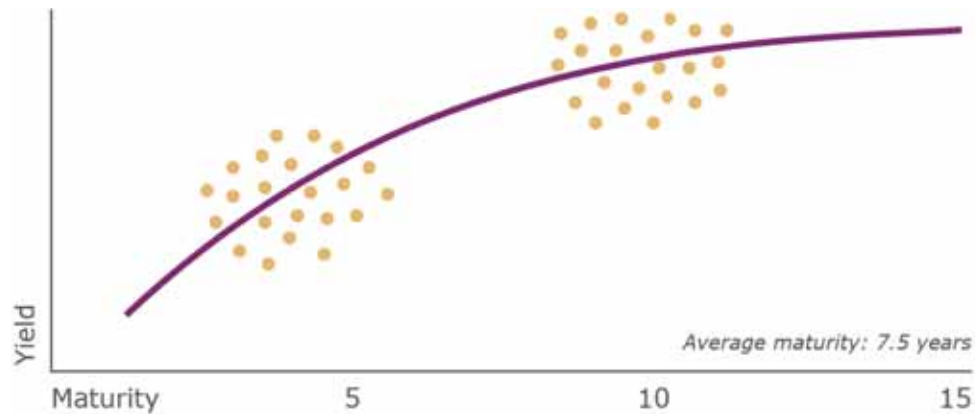


Yield-curve

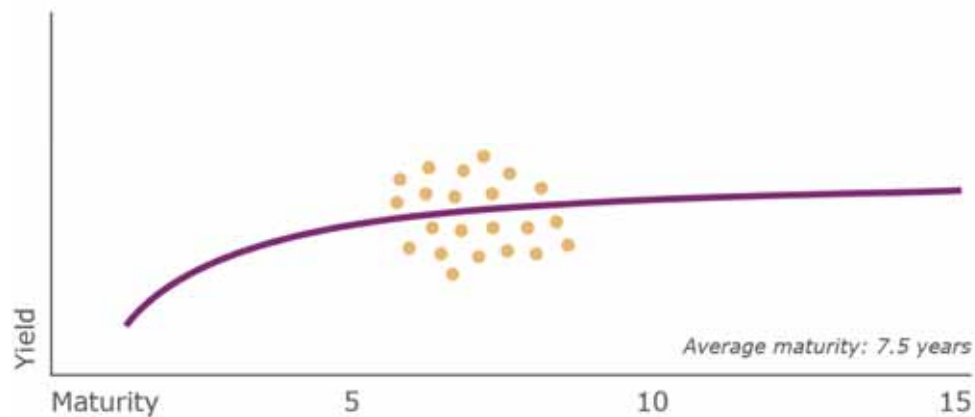
- Yield-curve positioning refers to the maturity structure of a portfolio and seeks to benefit from changes in the shape of the yield curve.

Yield-curve positioning

Match the strategy to the shape of the curve



Barbell
When we expect
the curve to flatten

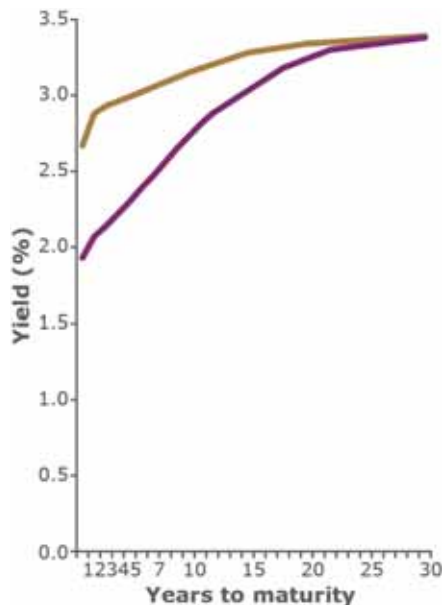


Bullet
When we expect
the curve to steepen

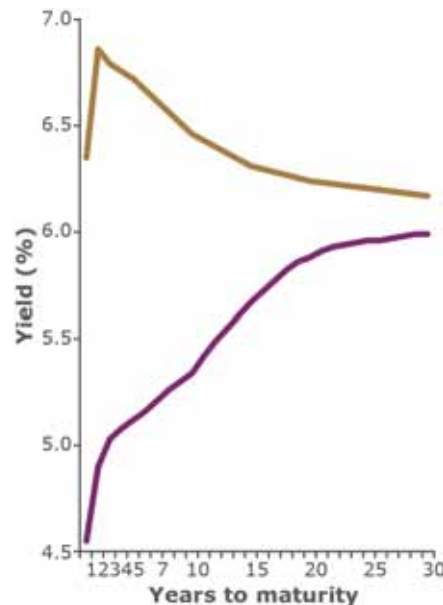
Yield-curve positioning

Historical analysis combined with fundamental and technical outlook results in optimal yield-curve positioning.

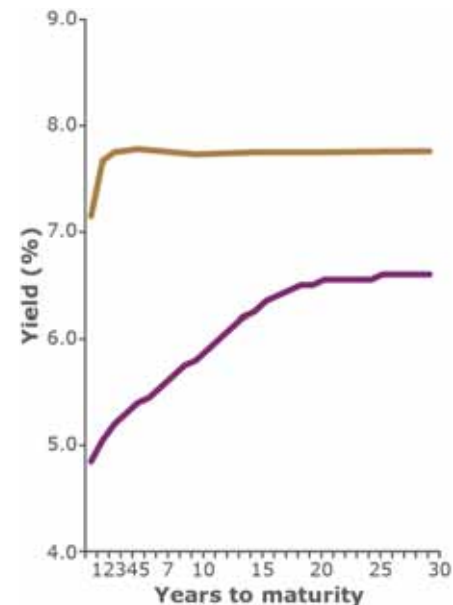
Current U.S. Treasury vs. sloped muni (10-31-18)



Inverted U.S. Treasury vs. sloped muni (5-15-00)



Flat U.S. Treasury vs. sloped muni (12-27-94)



Considerations

- Historical slope analysis
- *Roll down* return analysis
- Bullet versus barbell maturity structure
- Key-rate duration analysis

Yield-curve positioning

Conclusions:

- Tax-equivalent yield advantage of muni bonds will depend on the shape of both yield curves
- Persistent steepness of the muni curve historically rewards marginal maturity extension
- Changing relationship of muni to Treasury curves can create interesting opportunities

How to apply it



Yield-curve

- When the curve is expected to flatten, cluster bonds in areas shorter than and longer than the target duration.
- The barbell helps whether the short end rises or the long end falls.
- When the curve is expected to steepen, build a bullet surrounding the target maturity.

Driver #3: Allocating across sectors and credit



Sectors and credit

- Vary sector and credit exposures based on relative-value opportunities.

Allocating across sectors and credit

Look for relative-value opportunities

Rating	Municipal (%)	Corporate (%)
AAA	0.00	1.17
AA	0.04	1.48
A	0.17	2.79
BBB	1.07	6.14
BB	5.48	18.46
B	12.38	30.75
CCC/C ²	44.88	58.78
Investment-Grade	0.30	3.69
Speculative-Grade	10.37	27.50

Historically, a BBB muni bond has a cumulative default rate less than a AAA corporate bond

Source: Standard & Poor's municipal defaults from 1-01-86 to 1-01-18 and corporate defaults from 1-01-81 to 1-01-18. S&P's study calculations include all ratings in the C category, from CCC to C. **Past performance is no guarantee of future results.**

Allocating across sectors and credit

Mid-quality credits have outperformed

Calendar year total return by credit tier

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
HY 59.97%	HY 10.52%	HY 8.58%	HY 10.74%	AAA 3.84%	AAA 1.61%	HY 32.73%	HY 7.80%	A 12.53%	HY 18.14%	AAA -1.61%	BBB 14.47%	BBB 4.25%	HY 2.99%	HY 9.69%
BBB 8.35%	BBB 8.48%	BBB 8.33%	BBB 7.60%	AA 3.52%	AA -0.76%	BBB 26.09%	BBB 3.75%	BBB 11.84%	BBB 9.80%	AA -2.12%	HY 13.84%	A 3.71%	A 0.85%	BBB 8.74%
AAA 5.37%	A 5.35%	A 4.02%	A 5.26%	A 2.67%	A -5.97%	A 15.87%	A 2.23%	AA 10.28%	A 8.16%	A -2.56%	A 10.52%	AA 3.16%	BBB 0.35%	A 6.16%
AA 4.87%	AAA 4.21%	AAA 3.13%	AA 4.66%	HY -2.28%	BBB -21.3%	AA 11.72%	AA 2.05%	HY 9.25%	AA 6.23%	HY -5.51%	AA 8.22%	AAA 2.73%	AA 0.05%	AA 4.96%
A 4.48%	AA 3.87%	AA 3.09%	AAA 4.63%	BBB -2.73%	HY -27.0%	AAA 9.06%	AAA 2.03%	AAA 8.75%	AAA 4.52%	BBB -7.17%	AAA 6.34%	HY 1.81%	AAA -0.17%	AAA 4.45%
Rising yields				Financial crisis		Crisis recovery			PR & Detroit*		Credit recovery, Fed starts hiking*			

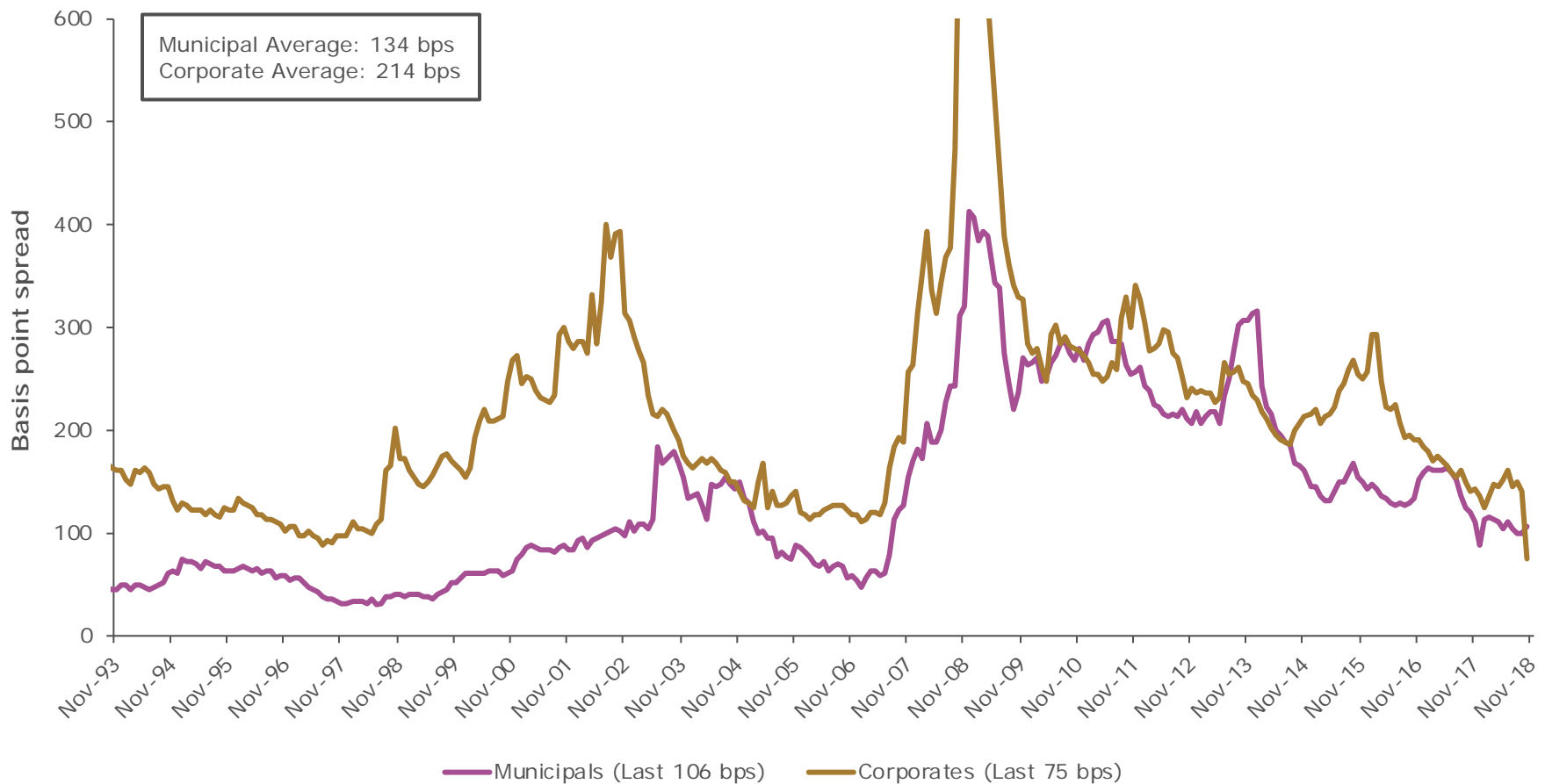
Dedicated credit analysis allows active managers to OPPORTUNISTICALLY MOVE UP AND DOWN credit quality to ADD VALUE for investors.

*Puerto Rico returns greatly influenced BBB returns in 2013 and HY in 2015

Source: Wells Fargo Asset Management, Barclays. Each credit tier is composed of the subset of securities in the Bloomberg Barclays Municipal Bond Index bearing the corresponding credit rating, as determined by Moody's Investor Service, Standard & Poor's, and Fitch Ratings Ltd.

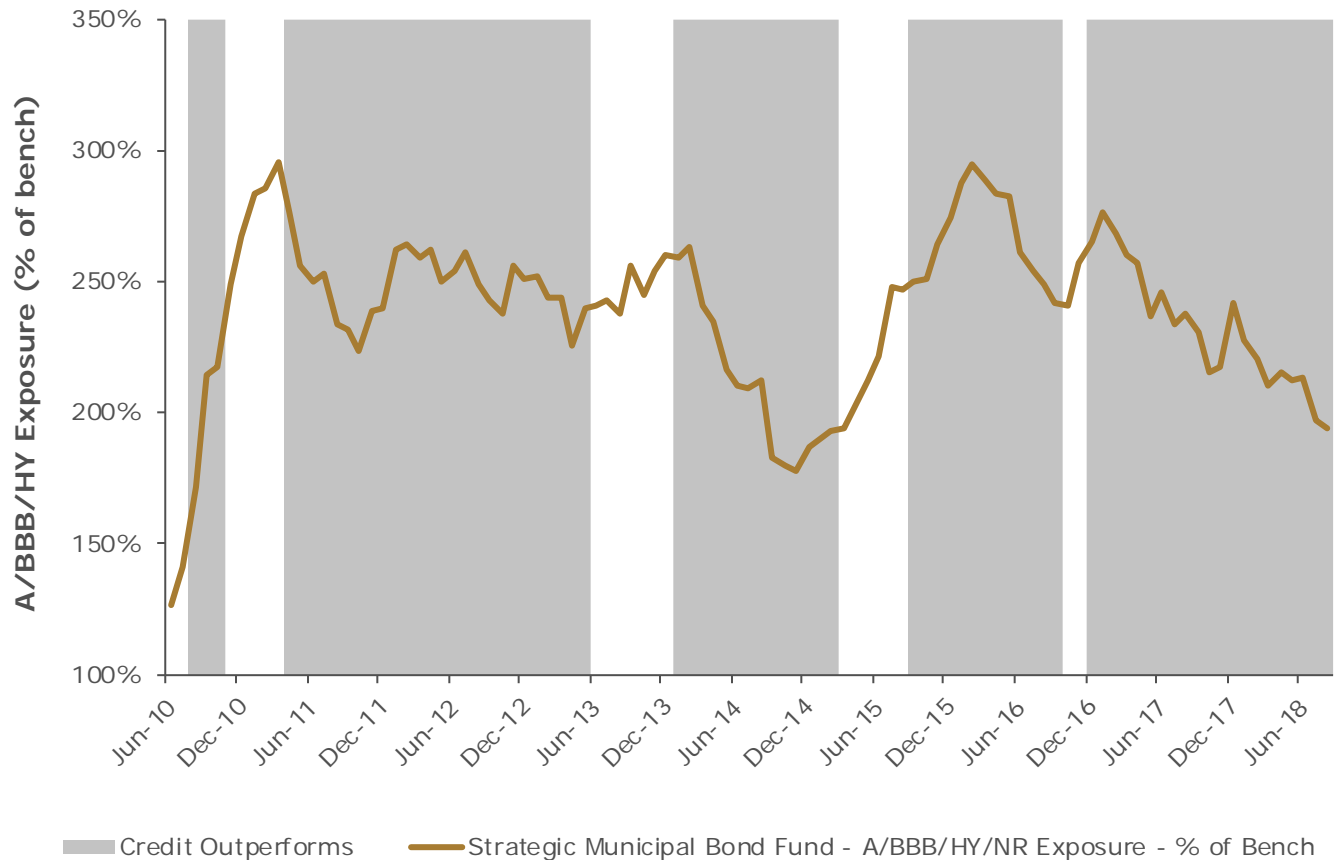
Allocating across sectors and credit

Opportunity in credit: AAA to BBB spreads



Sources: Wells Fargo Asset Management, Barclays Capital, based on the yield to worsts of the BBB municipal index less the municipal AAA index and the BBB Corporate index less the Treasury Index. As of 10/31/2018.

Allocating across sectors and credit



Wells Fargo Strategic Municipal Bond Fund credit allocation relative to its benchmark, the Bloomberg Barclays Short-Intermediate Municipal Bond Index

Sources: Wells Fargo Asset Management, MMD, Thomson Reuters, Bloomberg, and Barclays. As of 08/30/2018.

How to apply it



Sectors and credit

- Invest confidently in undervalued, lower-rated munis.
- Because the cheapness of lower-rated munis varies across cycles, moving up and down in quality may unlock additional income.
- Value can be found by investing in undervalued muni sectors.

Driver #4: Selecting securities



Security selection

- Careful security selection is vital to finding relative value and avoiding undue risks.

Selecting securities

The muni market is less efficient than other markets

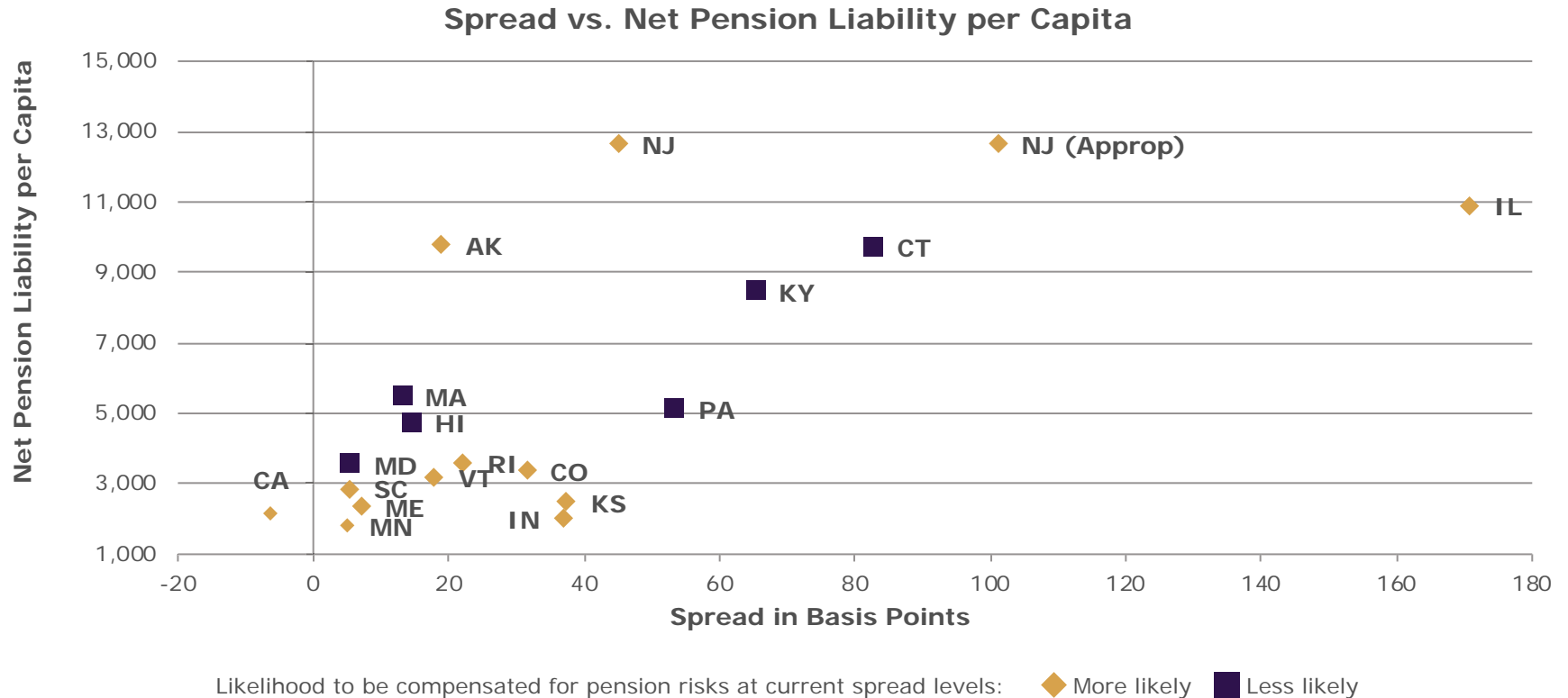
	Equities	Corporate Bonds	Muni Bonds
Market Size	\$50.0 T	\$7.7 T	\$3.7 T
Average Daily Volume	\$76.8 B	\$19.2 B	\$6.9 B
Average Daily Number of Trades	9,800,000	37,000	38,000
Average \$ per Trade	\$8,000	\$519,000	\$161,000
Number of Issuers	5,700	5,000	46,000
Number of CUSIPs	10,000	20,000	1,100,000
Percent Direct Retail	35%	10%	51%

Sources: EMMA, SIFMA, Bloomberg, NYSE/NASDAQ, TRACE, GAO, JP Morgan. Data as of 12-31-17.

Note: Data reflects U.S. market only, bond data excludes money market activity

Selecting securities

Credit research uncovers underappreciated risk



Source: Wells Capital Management, Bloomberg, State audited financials, U.S. Census Bureau, states with a per capita liability below \$2K were removed for illustrative purposes, spreads as of 8-31-18, census data as of 12-31-16, liability data as of most recent audited state financials, typically 6-30-17. New Jersey (NJ) GO debt is shown above but few exist, most issuance is appropriated, which is also shown.

How to apply it



Security selection

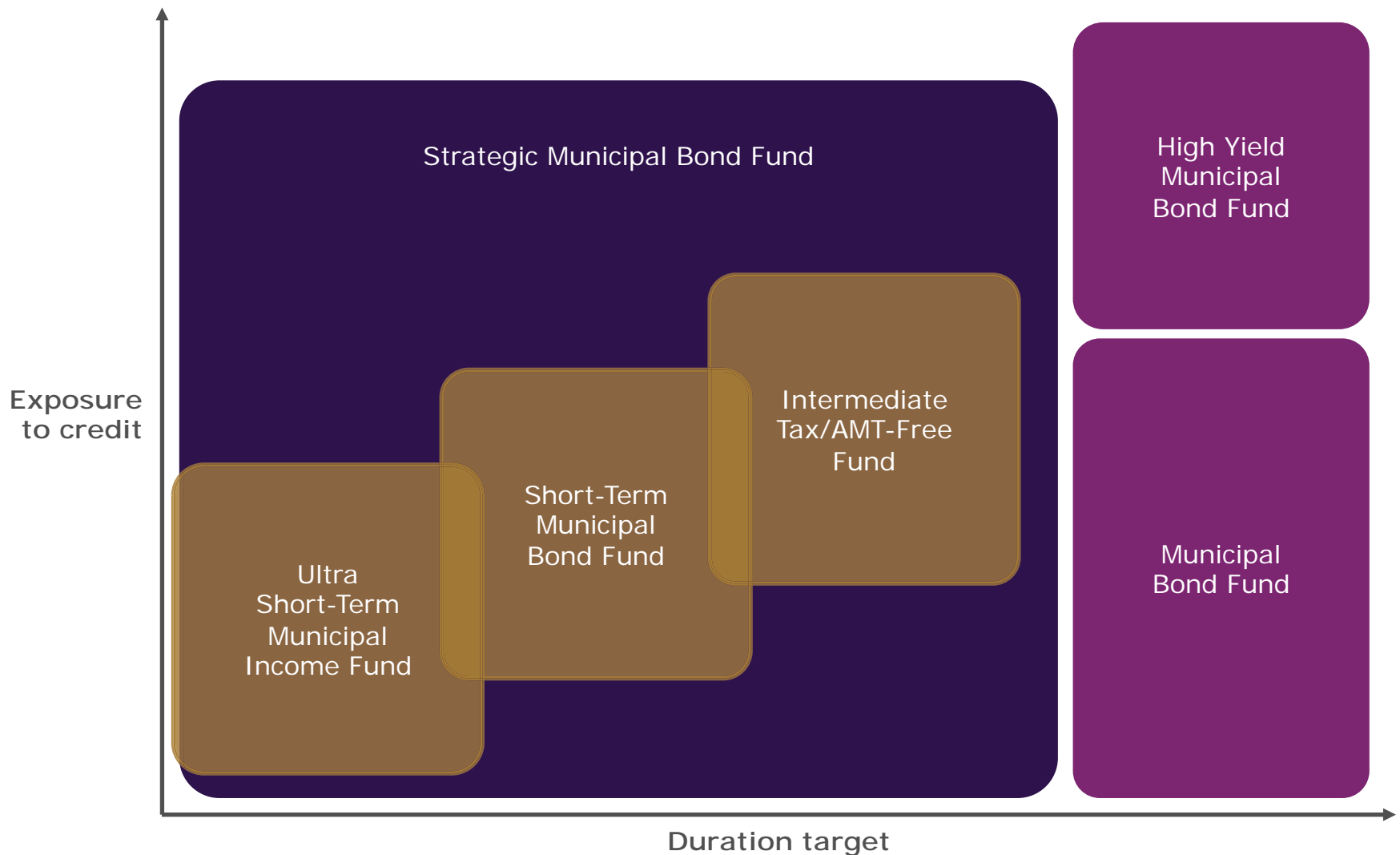
- Pair qualitative and quantitative screens to find securities with attractive risk/reward characteristics.
- Assign an internal rating for each security and assess the security's current price and yield given its inherent risks.
- Identify and capture security mis-valuations.

Key takeaways

- The amount each of the four sources contributes to total return varies over a business cycle
- We believe that having an investment process that seeks diversified sources of total return can:
 - Help mitigate portfolio volatility
 - Help generate upper-quartile, long-term returns



We offer a full lineup across duration and credit



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