LMCG INVESTMENTS®

Fixed Income

Q1 2018 REVIEW

FIXED INCOME COMMENTARY: Q1 2018

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Market Highlights

- The first quarter for the bond market came in like a bear and went out with only a slightly more bullish tone. Fears of inflation and tighter Fed policy plagued the bond market causing yields to rise.
- The slightly more bullish tone that emerged toward the end of the quarter was not enough for bonds to avoid posting their first negative quarter since 2016.
- The 10-year US treasury yielded 2.74% on March 31st, 33 basis points higher than where it began the quarter. Municipals outperformed equivalent-duration Treasuries before adjusting for taxes, but still generated negative returns. Credit was the laggard, underperforming both equivalent-duration Treasuries and Municipals for the third consecutive month.
- Duration was the biggest contributor to the bond market's weakness as yields moved higher across the yield curve. Short maturities outperformed intermediate and long maturities.
- According to the Blomberg Barclays Indexes, intermediate municipal bonds declined -0.71% during the quarter, while intermediate US treasury and corporate bonds dropped -0.73% and -1.36%, respectively.
- Much of the strength in the municipal bond market during the quarter was attributable to the marked drop in new issue supply; year-to-date issuance is lower by approximately 30% as a result of the new tax laws that no longer allow advance refunding issues.
- Federal Reserve officials met in March for the first time under new Chairman Jerome Powell. The committee raised the benchmark lending rate by a quarter percentage point and forecast a steeper path of rate hikes in 2019 and 2020, citing an improving economic outlook.
- In its forward guidance, the Fed's 2018 GDP growth forecast was revised upward slightly from 2.5% to 2.7%, but the longer-term 2020 forecast was unchanged at 2.0%. The core PCE inflation forecast for 2018 of 1.9% was unrevised, but was revised upward from 2.0% to 2.1% for 2019 and 2020.
- One interesting outcome from the Fed's March meeting was that, for the first time, they projected an inflation rate in 2020 above their 2% target rate.
- In a surprising twist, the price on some Puerto Rico defaulted bonds more than doubled in price during the quarter from about twenty to forty-five cents on the dollar. The influx of $70 billion of US federal hurricane relief funds and insurance money and news reports that the island may emerge with a small surplus caused the increase in bond prices. We do not own any Puerto Rico bonds, but in our opinion the rally does not appear sustainable – forecasting the recovery rate on defaulted bonds is a guessing game and the federal oversight board continues to call for more austerity.

LMCG Composite Performance

Our Core and Municipal bond strategies generated negative returns during the first quarter. The strategies were weighed down by the general rise in interest rates across the curve. Performance of our Core Bond Strategy was in line with the benchmark index during the quarter. Positive contributions from our duration and yield curve strategies and security selection was not enough to offset the drag from our overweight position to corporate credit. Performance of our Municipal Bond Strategy was also in line with the benchmark index during the quarter. While we generated positive contributions from our duration and yield curve positioning, it was not enough to offset some of the state specific concentrations due to our client account profile (e.g., Massachusetts is among our largest client concentrations, but the state's credits underperformed the benchmark index during the quarter).

LMCG Core Bond Composite Performance

As of 3/31/2018, US Dollar

		Annualized				
	Q1 2018	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Inception*
LMCG Core Bond (Gross)	**-1.5**	**1.2**	**2.1**	**2.3**	**4.1**	**4.6**
LMCG Core Bond (Net)	**-1.7**	**0.5**	**1.4**	**1.5**	**3.4**	**3.9**
Bloomberg Barclays Capital Interm U.S. Gov't/Credit Index	-1.0	0.3	0.9	1.2	2.9	3.7

*Inception: June 2006.

Past performance is not indicative of future results. Gross performance returns presented above are net of transaction costs and include the reinvestment of dividends and other earnings but do not reflect the deduction of investment management fees which would reduce returns. Net returns are calculated by applying the investment management fee schedule noted in the composite disclosure to the gross returns of the accounts included in the composite. For information regarding the impact of investment management fees on performance, please refer to the attached composite disclosure.

LMCG Municipal Bond Composite Performance

As of 3/31/2018, US Dollar

		Annualized				
	Q1 2018	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Inception*
LMCG Municipal Bond (Gross)	**-0.8**	**1.1**	**1.3**	**1.7**	**3.0**	**3.3**
LMCG Municipal Bond (Net)	**-1.0**	**0.3**	**0.5**	**0.9**	**2.3**	**2.6**
Bloomberg Barclays Capital 1-10 Yr. Municipal Bond Index	-0.7	1.2	1.4	1.8	3.3	3.6

*Inception: June 2006.

Past performance is not indicative of future results. Gross performance returns presented above are net of transaction costs and include the reinvestment of dividends and other earnings but do not reflect the deduction of investment management fees which would reduce returns. Net returns are calculated by applying the investment management fee schedule noted in the composite disclosure to the gross returns of the accounts included in the composite. For information regarding the impact of investment management fees on performance, please refer to the attached composite disclosure.

LMCG Outlook & Strategy

Inflation expectations have been one of the main drivers of higher yields in 2018, but now appear to have stalled – oil prices have stopped rising and consumer and producer price data have moderated. As we enter the second quarter, bonds continue to face significant challenges. We think Fed tightening remains a major concern for the bond market, but we also think investors' expectations for inflation and economic growth are too high.

Here are some of the supporting themes guiding our fixed income outlook and strategy:

- Weakness in the bond market in January and February was driven by inflation fears and tighter Fed policy, but concerns are now turning toward a potential slowdown in global growth. Economic data released in March, including retail sales, housing, earnings and inflation has slowed from levels earlier this year.
- Much has been made of the Fed's forecast of inflation in 2020 above their target. Our interpretation is that significantly higher inflation is not imminent and that the Fed is not likely going to react aggressively when it reaches their 2% target.
- The Fed's forecast for growth was revised higher, but only for this year and next. The longer run growth forecast remained unchanged at 2.0%. This suggests to us that the Fed believes that any economic boost to growth from fiscal stimulus is likely to be temporary.
- Tariffs and protectionist measures will not likely create lasting inflation. They may lead to temporary price increases, but they are likely to create greater downside to economic growth. Lower economic growth would likely force the Fed to take a more cautious approach to raising rates.
- The Fed appears steadfast in its forecast for two more rate hikes in 2018. We believe that will be the case unless weaker inflation and growth data emerge, which could alter their plan.
- The slope of the yield curve reached a new low during the first quarter of 49 basis points. We believe this is notable. In 2017, the spread between the 10-year and 2-year compressed because the Fed was becoming more aggressive in their tightening campaign. The recent new low in the yield curve has been driven by a decline in longer-term yields, which is a signal that the bond market is becoming worried about future growth.
- The sell-off in the corporate bond market has returned some value to the sector, but corporate spreads are still quite tight relative to history. Spreads could continue to widen if the earnings and the economic picture weaken further.
- The forecast for municipal bond supply is approximately 30% lower this year due to the tax reform bill, which will provide additional support to municipal bond prices in the face of Fed rate hikes.
- Demand from investors living in high tax states for in-state municipal bonds has increased significantly. We expect this to continue throughout 2018, thus supporting price gains in municipal bonds from those states.

We recommend that investors pay close attention to the recent economic data showing prices and economic growth moderating, as well as the potential for trade wars. Each of these developments would be a negative for stocks and a positive for high-grade bonds. Our investing goal is to remain defensive heading into the second quarter, but we are watching these economic and trade issues closely and are ready to move to a more aggressive investment stance if warranted. At this time, we remain short duration in our strategies relative to the benchmark indexes. We are biased toward taxable and tax-exempt municipal bonds as we expect them to outperform other taxable bonds as they have during prior tightening cycles. We have reduced our overweight to corporate credit, based on valuation and stage of the credit cycle, and increased our holding of US treasuries. We recommend a slight barbell yield curve positioning in our Municipal Strategy because of the relatively steeper yield curve versus taxable bonds. And finally, on the short end of the curve, we continue to purchase more defensive type securities in our Core Strategy in the face of further Fed tightening. They include floating rate notes, multi-step coupons and certificates of deposits.

CORE BOND COMPOSITE

Schedule of Annual Returns

January 1, 2007 through December 31, 2016

	Gross Returns (%)	Net Returns (%)	Benchmark Returns[1] (%)	Dispersion (bps)	Composite 3yr Ex Post Standard Deviation[2] (%)	Benchmark 3yr Ex Post Standard Deviation[2] (%)	Number of Accounts	Composite Assets at End of Period ($ millions)	Total Firm Assets ($ millions)
2016	4.4	3.6	2.1	91	2.1	2.2	23	46.6	7,367.5
2015	1.2	0.4	1.1	81	2.3	2.1	31	41.2	6,786.9
2014	4.7	3.9	3.1	76	2.3	1.9	30	40.3	6,370.5
2013	-0.5	-1.3	-0.9	44	2.3	2.1	26	36.7	5,831.5
2012	5.9	5.1	3.9	62	2.2	2.2	20	33.4	4,402.6
2011	6.3	5.5	5.8	65	2.6	2.6	18	29.8	4,200.7
2010	7.0	6.3	5.9	121	3.8	4.0	17	28.5	4,412.7
2009	9.3	8.7	5.2	124	3.6	3.8	15	27.1	4,365.1
2008	3.2	2.5	5.1	294	-	-	12	40.7	2,527.4
2007	6.8	6.1	7.4	42	-	-	15	49.3	4,124.5

[1] Benchmark returns have been obtained from an independent source and have not been examined by independent accountants.
[2] The three-year annualized standard deviation is not presented from December 31, 2006 through December 31, 2008 because the composite did not have 36 monthly returns in that time period.

Core Bond Composite: Portfolios included in this composite seek to earn consistent, above average returns while taking a low risk approach to fixed income asset management. The fixed income investment philosophy focuses on constructing high quality portfolios with an intermediate-term maturity structure. The portfolio invests in taxable fixed income bonds including but not limited to US Treasuries, Agency bonds and corporate bonds. All securities purchased are investment grade. The composite includes fully discretionary bond portfolios. For comparison purposes, the Barclays Intermediate Government/Credit Index is used. The minimum fixed income value requirement for inclusion in the composite is $750,000. The composite minimum prior to January 1, 2013, was $500,000. The inception date of the composite is June 1, 2006. The composite was created in October 2008.

Royal Bank of Canada (“RBC”) became LMCG’s indirect majority owner in November 2015 when RBC acquired City National Corporation (“CNC”). Effective January 1, 2015, Lee Munder Capital Group, LLC is known as LMCG Investments, LLC (“LMCG”), an investment adviser registered with the Securities and Exchange Commission. In July 2009, the firm was reorganized as an affiliate of CNC and took the name of Lee Munder Capital Group, LLC., prior to which it was known as Lee Munder Investments Ltd. (“LMIL”), which itself was an investment adviser registered with the Securities and Exchange Commission. The firm maintains a complete list and description of composites, which is available upon request.

The investment management fee schedule is as follows: Beginning January 1, 2011, 0.80% on the first $1 million and 0.77% on assets above $1 million. The prior fee schedule was 0.65% on the first $1 million and 0.62% on assets above $1 million. Actual investment advisory fees incurred by clients may vary.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The U.S. Dollar is the currency used to express performance. Performance results are presented gross and net of management fees and include the reinvestment of income. Net returns are calculated by applying the investment management fee schedule noted above to the gross returns of the accounts included in the composite. The annual composite dispersion presented is an asset weighted standard deviation calculated for the accounts in the composite the entire year. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

LMCG claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. LMCG has been independently verified for the periods October 1, 2000 through December 31, 2016. The verification report(s) is/are available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm’s policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. Past performance is not indicative of future results.

MUNICIPAL BOND COMPOSITE

Schedule of Annual Returns

January 1, 2007 through December 31, 2016

	Gross Returns (%)	Net Returns (%)	Benchmark Returns[1] (%)	Dispersion (bps)	Composite 3yr Ex Post Standard Deviation[2] (%)	Benchmark 3yr Ex Post Standard Deviation[2] (%)	Number of Accounts	Composite Assets at End of Period ($ millions)	Total Firm Assets ($ millions)
2016	0.1	-0.7	-0.1	37	2.3	2.4	56	113.7	7,553.4
2015	2.3	1.5	2.5	22	2.1	2.1	59	105.1	6,786.9
2014	4.3	3.5	4.7	43	2.1	2.2	57	102.4	6,370.5
2013	-0.3	-1.1	-0.3	72	2.3	2.5	51	91.6	5,831.5
2012	3.1	2.3	3.6	55	2.5	2.5	46	86.0	4,402.6
2011	6.8	6.0	7.6	52	3.3	3.2	42	73.0	4,200.7
2010	3.1	2.7	3.1	60	4.2	4.2	32	46.3	4,412.7
2009	6.2	5.8	7.2	132	3.9	3.9	18	18.5	4,365.1
2008	3.9	3.4	4.2	164	-	-	13	12.7	2,527.4
2007	4.5	4.1	4.8	47	-	-	13	13.4	4,124.5

[1] Benchmark returns have been obtained from an independent source and have not been examined by independent accountants.
[2] The three-year annualized standard deviation is not presented from December 31, 2007 through December 31, 2008 because the composite did not have 36 monthly returns in that time period.

Municipal Bond Composite: Portfolios included in this composite seek to earn consistent, above average returns while taking a low risk approach to fixed income asset management. The fixed income investment philosophy focuses on constructing high quality portfolios with an intermediate-term maturity structure. Value is added through issue and sector selection. All securities purchased are investment grade. The composite includes fully discretionary, municipal bond portfolios. The minimum fixed income value requirement for inclusion in the composite is $750,000. Prior to January 1, 2012, the composite minimum was $500,000. For comparison purposes, the composite is measured against the Barclays 1-10yr Municipal Bond Index. The inception date of the composite is June 1, 2006. The composite was created in January 2008.

Royal Bank of Canada (“RBC”) became LMCG’s indirect majority owner in November 2015 when RBC acquired City National Corporation (“CNC”). Effective January 1, 2015, Lee Munder Capital Group, LLC is known as LMCG Investments, LLC (“LMCG”), an investment adviser registered with the Securities and Exchange Commission. In July 2009, the firm was reorganized as an affiliate of CNC and took the name of Lee Munder Capital Group, LLC., prior to which it was known as Lee Munder Investments Ltd. (“LMIL”), which itself was an investment adviser registered with the Securities and Exchange Commission. The firm maintains a complete list and description of composites, which is available upon request.

Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. Account performance is calculated on a total return basis including income and realized and unrealized gains and losses. Composite performance is presented gross and net of management fees. Net returns are calculated by applying the investment management fee schedule noted below to the gross returns of the accounts included in the composite. The annual composite dispersion presented is an asset weighted standard deviation calculated for the accounts in the composite the entire year. The U.S. Dollar is the currency used to express performance. Policies for valuing portfolios, calculating performance, and preparing compliant presentations are available upon request.

The investment management fee schedule is as follows: Beginning January 1, 2011, 0.80% on the first $1 million and 0.77% on assets above $1 million. The prior fee schedule was 0.40% on all assets. Actual investment advisory fees incurred by clients may vary.

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