Parametric TABS Short-Term Municipal Bond Fund

Performance Review

In the quarter period ending June 30, 2023, the Portfolio’s I shares returned -0.38% (net of fees)\(^1\), while the benchmark returned -0.72%.

Parametric TABS Short-Term Municipal Bond Fund (the Fund) turnover for the period was approximately 11%. The primary driver of relative performance versus the benchmark, the Bloomberg Municipal Managed Money 1-7 Year Bond Index (the Index), was yield curve positioning, while the primary detractor from relative performance was the Fund’s overweight exposure to the housing sector. The Fund is higher quality than most peers and seeks to add value through skillful active management, particularly in times of market volatility or dislocations. Generally, managers leverage various techniques in pursuit of total return, including credit quality management, yield curve positioning, relative value trading, and sector selection — a crossover trade between tax-exempt and taxable securities.

A Word On The Markets

Financial markets remained choppy during the second quarter of 2023. They continued to digest multiple events, including and certainly not limited to: a potential debt default by the U.S. Treasury; uncertainty arising from the regional bank failures during the first quarter; and the Federal Open Market Committee (FOMC) continuing to hike rates, then pausing in June and stating that it could hike again in the future. Thankfully, Congress passed a deal to lift the debt ceiling, which was ultimately signed into law over the weekend of June 3, averting a crisis right ahead of the so-called X-date of June 5 (where the Treasury would essentially run out of money). The FOMC hiked the federal funds rate by 25 basis points (bps) in May to the 5%-5.25% level and then paused at its June meeting. Chairman Powell made it clear though that it could hike again in July, and maybe even September if economic data continues to come in strong and not cooperating per se with the committee’s agenda. Equities continued their march higher, putting recession worries aside, embracing strong employment reports and paying no mind to extreme volatility on the front end of the U.S. Treasury curve. For the quarter, the S&P 500 Index had a return of 8.30%, putting it higher year-to-date by 15.91%. Fixed income markets were choppy and munis were no exception. The Bloomberg Municipal Bond Index posted a -0.10% return, while the Bloomberg U.S. Treasury Index and Bloomberg U.S. Corporate Index were down by 1.38% and 0.29%, respectively. Two-year U.S. Treasury rates moved substantially higher during the quarter, primarily driven by the debt limit stress and the prospect of more rate hikes. Two-year, 10-year and 30-year U.S. Treasury yields were higher by 84 bps, 32 bps and 18 bps, respectively. The 2-10 year part of the curve remains inverted at a spread of -106 bps. Inflation continued its fall as the consumer price index printed 4% year-over-year with June’s report (down from its peak of 8.6% a year ago) and will continue, along with unemployment, to be a key determinant of next steps for the Federal Reserve.

After a strong first quarter in 2023, munis spent most of the second quarter in choppy waters but ultimately posted a total return of -0.10%. Returns were driven by June (+1.00%) as the market entered the seasonally strong technical period that sees net negative supply, meaning more bonds being called and maturing out of the market than new issuance. Munis also experienced negative performance in May, helping to reset valuations back to attractive levels for market participants. Municipal bonds outperformed their taxable counterparts as the Bloomberg U.S. Aggregate Bond Index returned -0.86%, while the Bloomberg U.S. Corporate Index was down by 0.29%. Like the U.S. Treasury curve, which has a 2-10s inversion of 106 bps, the muni curve also continues to find itself inverted. It is not as extreme as the U.S. Treasury curve, but the spread between the 2-10 year portion is -37 bps. Two-year AAA muni yields were higher by 55 bps, 10-year yields were up 29 bps and 30-year AAA muni yields rose 19 bps.

Just like the market, municipal mutual fund demand was choppy across the three months ending June 30. Flows ultimately ended lower, and according to Lipper, as of June 28, combined weekly and monthly reporting municipal mutual funds had outflows of negative $81 billion on a year-to-date basis. These outflows have been predominantly driven by short-dated funds though, as both long-term and high yield muni funds are showing inflows year-to-date. On the supply side of the technical picture, new issuance has been very manageable; according to BofA Global Research, it is about $161 billion as of June 21, which is lower by 19% year-over-year. Tax-exempt issuance is lower by 12%, while taxable issuance is down 44%.

\(^1\) Source: Parametric. Data as of June 30, 2023.

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For the quarter, the long end of the muni market outperformed. The Bloomberg Municipal Long Bond (22+ Year) Index was up 0.67%, the Bloomberg Municipal 10-Year Index was lower by 0.59%, and the front end of the market, as measured by the Bloomberg 1-Year Municipal Bond Index, was higher by 0.08%. The BBB portion of the investment grade credit spectrum posted the strongest return at +0.72%, while AAA munis were lower by 0.41%. The Bloomberg High Yield Municipal Index was up 1.65%. After a very challenging year in 2022 for taxable munis, the Bloomberg Taxable Municipal Bond Index is higher for the year by 4.75%, far outpacing both investment grade and high yield corporate bonds.

**Contributors**

The contributors to relative performance in the second quarter included yield curve positioning, duration management and a crossover trade between tax-exempt and taxable securities. Yield curve positioning was the primary driver of relative performance, as overweight exposures to securities in the steeper segment of the municipal yield curve aided performance. Additionally, duration management was additive to relative performance as interest rate volatility continued throughout the quarter. Lastly, the Fund’s allocation to taxable securities via a crossover trade also aided performance.

**Detractors**

The Fund’s overweight allocation to the housing sector was the primary detractor from relative performance during the second quarter. This sector lagged the broader Index by 64 basis points during the period and, as such, the excess exposure weighed on relative performance.

**Investment Outlook And Fund Positioning**

We continue to believe that interest rate movements will remain choppy and that municipal bonds could experience a relatively positive second half of 2023. As mentioned before, the muni market is currently in a seasonally strong technical period, and it looks as if new issuance for the year will remain below last year’s levels. Interest rates on the front end of the muni curve are at levels not seen in well over a decade, and even further out the curve, munis are attractive from not only a risk-to-reward perspective, but also on a tax-equivalent yield basis. As the FOMC potentially ends its rate-hiking regime, we think that yields will ultimately move lower. There will be a number of items to watch in the third quarter, particularly how the U.S. economy performs regarding employment, consumer spending, inflation gauges, etc. Equity market and rate volatility will be watched closely, as will of course the ultimate end game for the FOMC.

In terms of technicals, we will be keeping a close eye on muni mutual fund flows. If you recall, 2022 was the worst year ever for outflows from muni funds, and as tax-loss harvesting slowed entering the new year, we will be eager to see if outflows can slow or, better yet, find a reversal to inflows. Unfortunately, year-to-date muni mutual fund flows are negative, largely driven by short-dated funds, but on the other side of the picture are strong inflows into separately managed accounts. Current yield levels certainly present a buying opportunity in our view, but we appreciate that volatility remains. We will also be watching the new-issue market closely. After a light second quarter for new issuance, expectations for year-end supply have moved lower; but with six months of the year left we could see an uptick, especially if yields move meaningfully lower after the FOMC is done hiking the federal funds rate.

Municipal bond exposure may help stabilize portfolios if investor appetite shifts to relative safe-haven assets, particularly as the worry of a U.S. recession remains on market participants’ minds. We are actively assessing ratios of tax-exempt municipals to Treasuries, taxable munis and investment grade corporate bonds. At current valuations, munis appear relatively attractive for virtually all muni buyers, which could provide some continued much-needed support for the market entering into the second half of 2023. Finally, as rates remain near multiyear — and in some instances decades-long — highs, today’s environment could prove worthwhile for adding to muni exposure, particularly for the longer-term-minded investor.

**Fund Facts**

<table>
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<th>Class I inception</th>
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<td>Performance inception</td>
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<td>Benchmark</td>
<td>Bloomberg 5 Year Municipal Bond Index</td>
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<td>Class I expense ratio</td>
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Where the net expense ratio is lower than the gross expense ratio, certain fees have been waived and/or expenses reimbursed. These waivers and/or reimbursements will continue for at least one year from the date of the applicable fund’s current
RISK CONSIDERATIONS: The value of investments held by the Fund may increase or decrease in response to economic, and financial events (whether real, expected or perceived) in the U.S. and global markets. There generally is limited public information about municipal issuers. As interest rates rise, the value of certain income investments is likely to decline. Investments in debt instruments may be affected by changes in the creditworthiness of the issuer and are subject to the risk of non-payment of principal and interest. The value of income securities also may decline because of real or perceived concerns about the issuer’s ability to make principal and interest payments. The Fund is exposed to liquidity risk when trading volume, lack of a market maker or trading partner, large position size, market conditions, or legal restrictions impair its ability to sell particular investments or to sell them at advantageous market prices. Income from tax-exempt municipal obligations could be declared taxable because of changes in tax laws, adverse interpretations by the relevant taxing authority or the non-compliant conduct of the issuer of an obligation. A portion of the Fund’s distributions generally will be subject to the federal alternative minimum tax. The Fund may not be suitable for investors subject to the federal alternative minimum tax. The impact of the coronavirus on global markets could last for an extended period and could adversely affect the Fund’s performance. No fund is a complete investment program and you may lose money investing in a fund. The Fund may engage in other investment practices that may involve additional risks and you should review the Fund prospectus for a complete description.

INDEX INFORMATION: Bloomberg 5 Year Municipal Bond Index is an unmanaged index of municipal bonds traded in the U.S. with maturities ranging from 4-6 years.

Bloomberg Municipal Managed Money 1-7 Year Bond Index is an unmanaged, tax-exempt bond market index that measures the 1-7 year maturity component of the Bloomberg Municipal Managed Money Bond Index and such Index performance is available as of month end only.

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of the fund

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