How to Raise Credit Quality - A Five States Synopsis

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August 18, 2021

Lessons learned over the record-long economic expansion during the prior decade is that it is possible to improve state credit quality even when faced with challenging structural issues. States tend to be large entities with many competing interests, where major policy shifts can be slow to materialize. For the most part, state credit tends to be quite stable, and changes to credit ratings, particularly a succussion of changes in one direction, are unusual. In the summaries that follow we highlight five states that, in our opinion, have managed to do a commendable job in turning around credit quality. Not all the states are highly rated, and some have a lot more work to do to maintain a positive trajectory, but their efforts at making improvements have caught the municipal market's attention. What made the difference for these five states encompass relatively fundamental aspects of fiscal management, and in broad strokes entail 1) a collaborative effort at regaining structural budget balance in the face of significant headwinds, 2) a demonstrated willingness to set aside funds for a "rainy day" when economic times improve, and 3) following strong governance principles to ensure consistency across budget cycles. For the states where adhering to these budget management components was less onerous, low levels of debt and pension liabilities were present from the start. And of course, a favorable climate (business or otherwise) doesn't hurt either.

Arizona

One year after the 2008 recession ended[1] Arizona's financial position remained weak, partially attributed to the significant impact that the housing market downturn, and related jobs destruction and home inventory overhang, had on the state's economy. Revenue was underperforming budget causing the state to run large deficits, which were filled by drawing on reserves. Compounding the budget problems were policymakers' reliance on non-recurring budget solutions, which prevented structural budget balance from being attained. Federal government mandates related to Medicaid funding ratcheted the financial burden on the state further still. Arizona's financial flexibility was constrained by voter-initiated spending mandates and a 2/3 legislative majority vote requirement, or vote of the electorate, to increase taxes. Taken together, the expenditure mandates, recently passed and perhaps ill-timed tax cuts, coupled with a housing market-led recession led the state to initially take the path of least resistance by relying on one-time budget maneuvers, including the issuance of deficit bonds. Accordingly, the resulting structural imbalance worsened and forecasts from the credit rating agencies projected that the state would lag in the economic recovery because the housing market downturn was affecting the state's economy more than other states.

[1] National Bureau of Economic Research dated the recession from December 2007 to June 2009.

Approximately 2 ½ years after the recession ended Arizona's fiscal picture began to improve. The state opted for carrying out the budget decisions necessary for restoring structural balance by making temporary and permanent expenditure reductions and enacting a temporary one-cent sales tax increase. Combined with the earlier non-recurring measures of reserve draws and deficit bonds the state eliminated a substantial accumulated deficit, allowing it to project a positive balance into subsequent years as its permanent budget solutions were expected to bear fruit. At the same time, housing prices stabilized, underpinning the state's economic performance. As Arizona's economy continued to recover, the state's prior budgetary solutions resulted in strengthening liquidity and financial flexibility. Further aiding in the state's improving credit profile was its moderate debt burden, limited debt issuance plans, and below average pension liabilities. Arizona's economy also benefited from continued strong population growth due to its favorable climate and business environment.

It took nearly six years from the recession's end for Arizona to receive its first round of credit rating upgrades from the rating agencies[2]. The state's improved fortunes were driven by positive economic trends along with budget actions that eliminated a structural imbalance and began the process of building reserves. While the expiration of the temporary sales tax[3] opened a structural imbalance, conservative budgeting allowed tax revenue growth to outperform expectations and limit the disruption to the state budget that the expiring sales tax initially caused. Nevertheless, while Arizona's debt and pension liabilities remained below average, the state had a way to go to reach the level of reserves that it maintained before the recession began. Fortunately, the state's inherent attractiveness to broad swaths of the population continued to fuel its economic growth and tax revenues in the years ahead, while spending restraint promoted the rebuilding of reserves and the reduction to its already-low debt burden. The state retired debt incurred in the wake of the recession and limited new borrowing at the same time as its pension liabilities remained below average. Driven by its budget discipline and limited liabilities, in November 2019, Arizona scored another upgrade to its credit rating[4]. When the COVID-19 recession hit in March 2020, the state was adequately prepared judging by its significantly increased reserves from their low point in 2010.

California

California's economy and finances were hit particularly hard by the 2008 recession owing, in part, to a) the rampant housing market speculation that left a hole in economic activity once it ceased, to b) the state's volatile revenue structure tied to capital gains and the highest income taxpayers, and c) to large expenditure mandates which make belt-tightening during recessions

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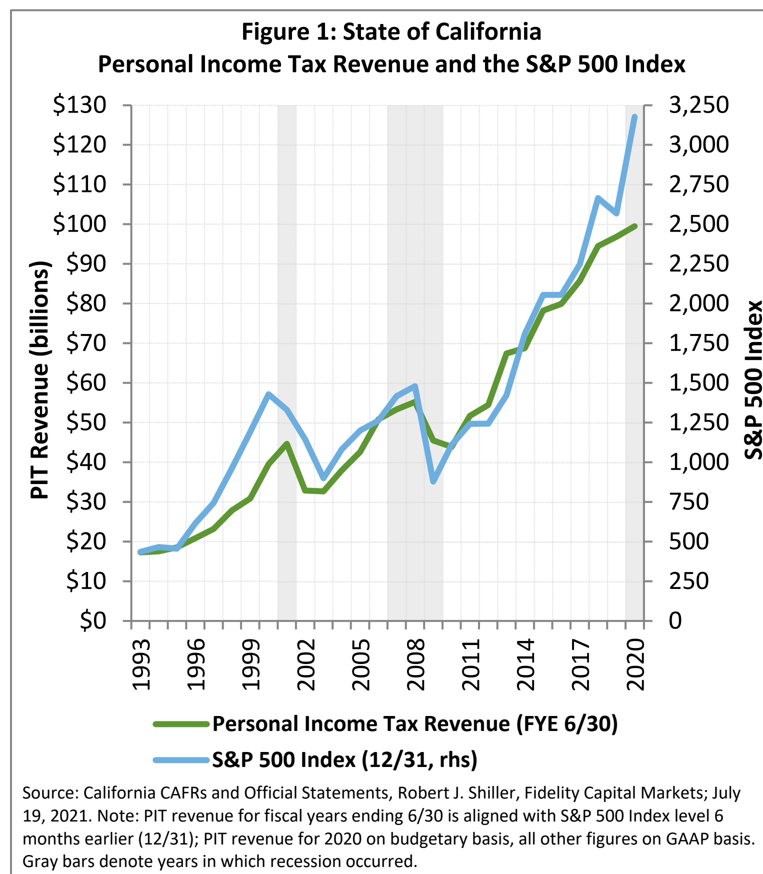
[2] Moody's Investors Service upgraded Arizona to Aa2 from Aa3 on 4 May 2015, followed by an upgrade by S&P Global Ratings to AA from AA- on 20 May 2015.

[3] The temporary sales tax expired at the end of 2013.

[4] Moody's Investors Service upgraded Arizona's rating to Aa1 from Aa2 on 19 November 2019.

nearly impossible. California's newly "re-minted[5]" Governor, Jerry Brown, moved almost immediately to shore up the state's finances. First, by using an assortment of nonrecurring measures to stabilize the yawning budget gap that had opened-up, and second, by leading the legislature and the electorate to make historic and permanent changes to the state's budgetary process – putting the state on a path to better navigate future recessions. Within two years of his inauguration S&P Global Ratings upgraded the state to A from A-. At the time, California's budget situation had stabilized on an improved fiscal condition and growing liquidity, allowing the state to conservatively project the maintenance of a structurally balanced budget for the next several years. The backlog of payment deferrals the state owed to its public school districts and internal loans between the state's many funds, both of which arose as early solutions to offset underperforming tax revenue, were also expected to be retired sooner than expected.

California has significantly less flexibility relative to other states when it comes to budgeting and raising revenue, making contingency reserves even more important. For example, approval by 2/3 of the legislature is required to raise revenues, and in a year when revenues are underperforming, the Governor does not have the power to order significant spending cuts or to raise revenues without the consent of the legislature. The state also revises its revenue forecasts less frequently than other states, giving it less time to catch up in a downturn. Furthermore, the state's system of voter initiatives and referenda has resulted in costly expenditure mandates, while voter approval is required to issue general obligation or deficit bonds. The state has a highly progressive personal income tax structure and taxes capital gains at the same rate as other income – tying a large portion of taxes received to a small portion of taxpayers, which leads to a higher level of revenue volatility relative to other states partly because tax revenues are closely linked with equity market performance (see figure 1).



Source: California CAFRs and Official Statements, Robert J. Shiller, Fidelity Capital Markets; July 19, 2021. Note: PIT revenue for fiscal years ending 6/30 is aligned with S&P 500 Index level 6 months earlier (12/31); PIT revenue for 2020 on budgetary basis, all other figures on GAAP basis. Gray bars denote years in which recession occurred.

[5] Edmund Gerald Brown Jr. served as the 34th and 39th Governor of California, from 1975 to 1983 and from 2011 to 2019.

Combined with the state's structural inflexibility, volatility of revenues leads to steep downturns in periods of economic decline, with fewer available solutions. Under the leadership of Governor Brown, the state made important changes to the way budgets are passed and to fiscal discipline. The supermajority requirement for passing the budget was a major contributor to past fiscal crises resulting in late budgets and spiraling deficits. In 2010, California voters approved Proposition 25, which removed the mandate that budgets be approved by a 2/3 vote in the legislature, with only a simple legislative majority now required, and lawmakers lose pay for every day after June 15 that they wait to approve a spending plan. Additionally, voters in 2014 passed Proposition 2, a constitutional amendment that created a rainy-day fund and a debt repayment requirement for the state composed of annual deposits from dedicated tax sources once certain benchmarks have been met. Voters also passed amendments that temporarily increased statewide sales and personal income tax rates, capitalizing on an economic recovery in full swing. Fixing the state's fiscal structure better aligned revenues and expenditures, and, in hindsight, was accomplished in the relatively short order of two budget cycles. In concert, these factors helped the state reverse it previous boom-bust fiscal course. Adherence to the new budget rules with an emphasis on debt retirement, including paying down the deficit bonds issued during the recession, contributed greatly to strengthen California's credit profile, and in June 2014, the state was upgraded into the “AA” category[6], a position it last surrendered nearly 13 years earlier.

In subsequent years, adherence to fiscal discipline allowed California to continue to build reserves toward the strongest levels in decades and gave it the flexibility to make much-needed pension reforms. Nearly six years on from the end of the recession the state continued to see positive rating actions with an additional upgrade in 2015, as well as a more recent positive action in 2019[7]. Much of California’s success can be attributed to the robust performance of it tax revenues, which have outperformed expectations on account of the strong equity market. Recent years have also shown that the legislature has followed a restrained approach to setting fiscal policy. Rather than using aggressive budget assumptions to justify higher spending, lawmakers have largely rode the wave of financial markets to a bigger budget. This approach has enabled the state to generate modest, yet steady surpluses that by law have been transferred to the rainy-day fund. Going forward, California's disciplined approach to managing revenue growth will remain squarely balanced against the aforementioned challenges, the most significant of which are high revenue volatility, lower spending and revenue-raising flexibility, and above average fixed costs for debt and pensions.

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[6] Moody’s Investors Service upgraded California’s rating to Aa3 from A1 on 25 June 2014. On 5 November 2014 - S&P Global Ratings raised California to A+ from A.

[7] S&P Global Ratings raised California to AA- from A+ on 2 July 2015 and Moody’s Investors Service upgraded the state to Aa2 from Aa3 on 14 October 2019.

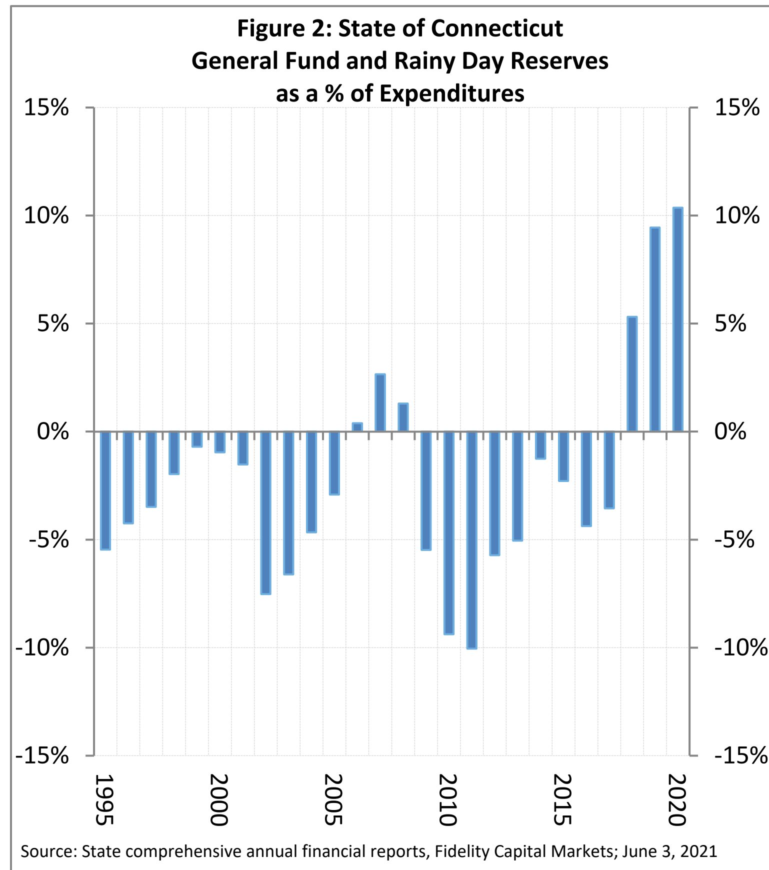
Connecticut

Connecticut's credit standing had been on a downward path since at least 2002 when a series of prior reforms began to pay off by early 2019. The state had been carrying a negative reserve position (an accumulated deficit) since the 1990s, and debt and pension metrics had been allowed to grow to near the highest among the 50 states. Connecticut has limited local government functions at the county or school district level, which has pressured debt higher over the years because the state absorbs costs such as teacher pension contributions, retiree health benefits, and debt service covered by local governments in most other states. Connecticut's assumption of the City of Hartford's general obligation debt in 2018 further exacerbated the problem. Meanwhile, unfunded pension problems compounded due to the state's use of an aggressive (high) discount rate assumption and a permissive funding approach linked to assumed wage growth. Reforms started under former Governor Dannel Malloy, and continued and expanded by the current Governor, Ned Lamont, resulted in, among other positive developments, replenished reserves. Governor Lamont also committed to keeping the state on a "debt diet" to ensure liabilities don't escalate further. State general obligation bond covenants imposed in 2018 require revenue to be set aside into reserves whenever certain benchmarks are met. This particular measure, along with bonds issued to close the legacy accumulated deficit, have brought Connecticut's combined reserves to the highest level in two decades. Positively, a supermajority legislative vote is still required to drawdown reserves. Further limiting the state's liabilities from growing via keeping spending in check was a constitutional spending cap that became effective in 2018. A separate set of reforms targeting unfunded pension liabilities pushed out amortization schedules, first for state workers (in 2016) and later for teachers (in 2019), lowered discount rates, phased in a level-dollar amortization approach, and has committed the state to making the full actuarially required payments.

In 2021, Connecticut received its first upgrades in more than 18 years[8] in the face of burdensome debt and pension liabilities and challenging demographics related to population loss. The bottom line for the rating agencies was the state's continued commitment to numerous governance improvements that bore fruit in terms of building reserves (see figure 2),

[8] Moody's Investors Service upgraded Connecticut to Aa3 from A1 on 31 March 2021 and S&P Global Ratings upgraded the state to A+ from A on 13 May 2021.

limiting debt issuance, funding pensions, and maintaining structural budget balance. For Connecticut, reserves are critical because the state has limited flexibility in funding pensions on account of the new reforms and revenue volatility is higher than other states due to the presence of a graduated income tax structure that relies heavily on top earners. Factors beyond the state's control have also provided a tailwind. In addition to a strong equity market that disproportionately benefits the state's top income taxpayers, Connecticut benefits from defense contracts for aerospace and submarine programs that are heavily dependent on federal defense spending. The recently enacted National Defense Authorization Act[9] includes large contracts that will advantage Connecticut-based employers.



States are sub-sovereign entities that have wide latitude to pass, implement and interpret statutes which can dramatically alter spending and tax policy, and thus, governance plays an outsized role in maintaining credit quality for the 50 states. While Connecticut's past practices had led it into a difficult situation, the state's governance structure is sound, in our opinion, allowing it flexibility to implement credit-supportive best practices. For example, budgetary performance is closely tracked with binding consensus revenue forecasting conducted at least three times a year, annual multi-year fiscal accountability reports are produced by the executive and legislative branches of government, and budget updates are generated monthly – making late budget adoption all but extremely unlikely. Furthermore, while most state constitutions require a balanced budget, in Connecticut's case this provision is given greater strength by adherence to GAAP-basis budgeting[10] – a reform initiated by Governor Malloy.

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[9] H.R.6395 - William M. (Mac) Thornberry National Defense Authorization Act for Fiscal Year 2021

[10] GAAP, or Generally Accepted Accounting Principles, refers to common accounting procedures, standards and principles set by the FASB. On the other hand, budgetary basis, used in most state budgets, refers to an accounting reporting method that uses the cash plus constraint or a modified accrual basis method to maintain accounting records and prepare budgets, and may be thought of as less stringent than GAAP.

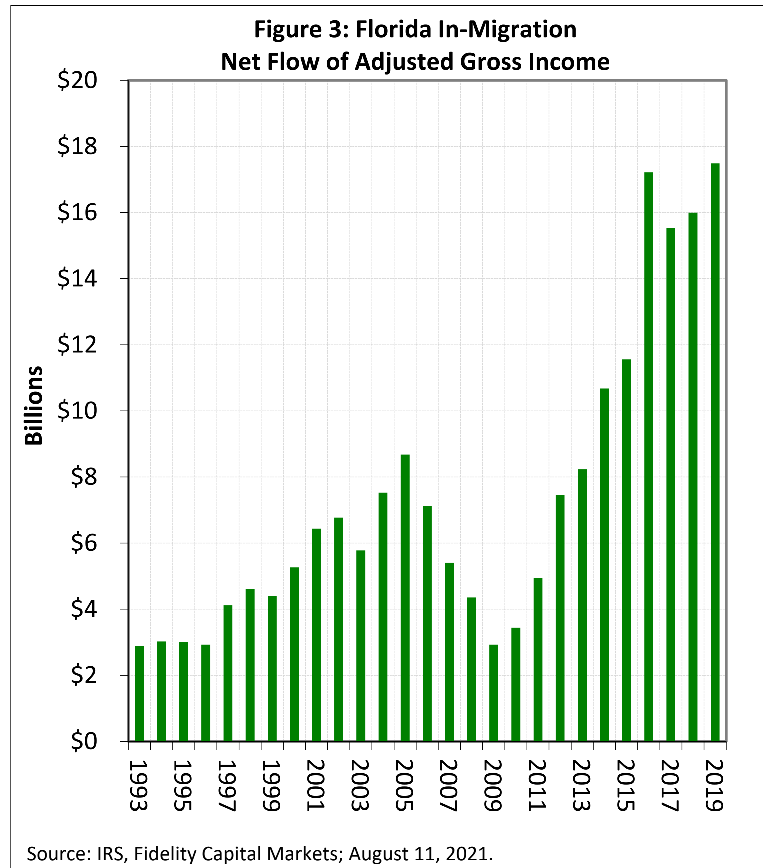
Additionally, supermajority requirements to enact tax increases, mandated initiatives, and voter referenda do not constrain the budget process. The governor also has executive authority to cut expenses midyear without legislative approval within certain limits. Another key governance feature keeping budgets inline is that midyear deficits exceeding 1% require a deficit mitigation plan.

By committing to reforms in recent years Connecticut now faces several budget cycles that will be more constrained compared with historical experience. Though given the long-term financial challenges it faces, the reforms have become all the more urgent. Through the enactment of a number of measures designed to restrain spending and debt growth, rebuild reserves, and improve the condition of its pension funds the state has set itself on a path to better fiscal health. Bondholders should be doubly pleased as some of these provisions are now required by bond covenants and constitutional amendments.

Florida

Effectively turning around deteriorating credit quality has not solely been exhibited by states with below average credit ratings, such as those that might be facing long-term structural headwinds. Whether the challenges are primarily internal, such as in California's case, where an inflexible budgetary structure exacerbated the amplitude of economic ups and downs, or primarily external, such as in Connecticut's case, where changes in industry and demographics contributed to unsustainably rising debt levels, some states have successfully stepped up to the challenge. In certain cases, however, the challenge of turning around a deteriorating credit situation may also apply to a state with relatively pristine credit metrics, which must make timely decisions in the face of an abrupt cyclical U-turn in order to maintain credit quality.

Florida has a service-based economy that depends significantly on tourism and in-migration[11] (see figure 3), which exposes the state to economic cyclicality. Coming out of the 2008 recession Florida faced increasing economic and financial pressures. Given the nature of the economic decline the state's economy was particularly hard hit as higher unemployment, a significant housing inventory overhang, high foreclosure rates, and rising Medicaid expenditures all contributed to what was expected to be a slow economic recovery. In 2009, revenues had declined for two years, demanding large reserve draws coupled with spending cuts as the state does not have an income tax and is reliant on economically sensitive sales taxes. In Florida's case, policymakers proactively reduced expenditures, enacted one-time revenue enhancements, conducted fund sweeps to shore up liquidity, and drew on reserves to maintain budget balance. Because the state's debt burden was already manageable and recurring revenue sources were underperforming policymakers temporarily allowed new borrowing to increase debt modestly above the state's debt affordability cap – thereby maintaining flexibility in other budget areas. Despite surpassing the self-imposed cap, debt levels never became a constraining credit factor.



Two years after the recession ended Florida's financial situation had stabilized owning to the progress the state made in rightsizing its budget and returning it to structural balance. Through

[11] In-migration is measured in terms of shifts in adjusted gross income (AGI) between and among the states. Looking solely at changes in a state's population may provide limited value in this regard because it does not directly measure changes in the tax base. Rather, the migration of AGI between and among the states provides a more accurate measure of the trend in a state's tax base in our opinion. The Statistics of Income Division of the IRS maintains records of all individual income tax forms filed in each year, including the state of residence of the filers. The data used to produce the migration statistics come from individual income tax returns and represent between 95% and 98% of total annual filings. One gauge of the degree of movement in a state's tax base is the extent to which it is on the sending or receiving end of AGI migration. The net dollar flow of AGI between Florida and other states provide a good indication of how the state's tax base is changing.

conservative budgeting prior to the recession's start, which created substantial reserves, and by not shying away from enacting significant cost-cutting measures during the downturn, which prevented the state from completely depleting its reserves, the state was back on firm financial footing by 2012 and replenishing its trust fund reserves as the economy recovered.
While it may come as a surprise to some, Florida's coveted three "AAA" ratings[12] are a relatively new phenomenon. Moody's had upgraded the state only in June 2018 to its highest rating. Certainly, a sustained trend of strong economic activity aided Moody's decision, though effective management of state finances played no small part too. Over the years, Florida has allowed reserves to build while limiting new debt and pension liability growth, resulting in low state debt and pension ratios. The state also exhibits strong governance practices so vital to U.S. state credit quality. Another effective policy – this one directly supporting the state's economy – has been one aimed at protecting real estate values (key to Florida's rapidly developing coastal communities). Through well-capitalized state-run property insurance companies Florida has reduced liability risks stemming from hurricane-related damages, even as the state insurers have been able to cut insurance-in-force exposure while increasing their claims-paying resources. Today, the state's long-term growth prospects are favorable even as it faces demographic challenges from an aging population base. Florida's sound fiscal management has been shown to operate effectively across economic cycles and state government administrations, underscored by a willingness to address budget imbalances as they arise while maintaining strong reserve levels – all the more important given the state's reliance on economically-sensitive revenues to support operations.

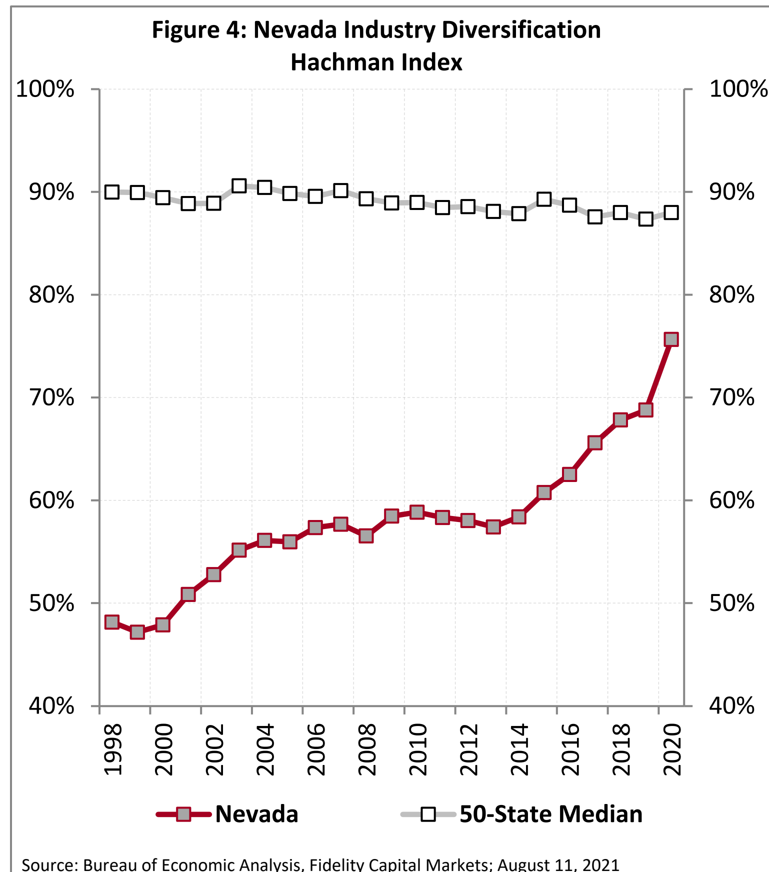
Nevada

Similar to Florida's heavy dependence on discretionary consumer spending, or perhaps more so, Nevada's credit also suffered erosion in the wake of the 2008 recession for many of the same reasons. While Nevada was impacted by many of the same factors as Florida, the state endured a longer contractionary period than most other states – spending three fiscal years in a recessionary context and being the last state to see its unemployment rate come down from double-digits. However, Nevada, like Florida, showed a willingness to address budget gaps with timely and, when necessary, severe cuts in spending and functional revenue shifts. The sometimes-overlooked benefit to keeping operating fund balance through difficult operating environments is the preservation of inter-year financial liquidity – something Nevada was able to do consistently. Throughout the retrenchment Nevada state bondholders enjoyed constitutional protections not shared by other states. For example, debt service is given priority over revenues, and in addition to pledging its full faith and credit, the state is required to levy a property tax to pay general obligation bond debt service to the extent other monies are not available.

[12]As of 10 August 2021, Moody's Investors Service rated Florida Aaa, S&P Global Ratings AAA, and Fitch Ratings AAA.

Once the dust from the recession had settled it was clear that a structural shift away from home building and housing market speculation had taken place in Nevada's economy. When combined with a relatively narrow industry focus on gaming and tourism the state's financial flexibility had decreased substantially and the road to recovery appeared bleak. As the state, like Florida, does not have an income tax, the collapse of the real estate market led to big declines in core revenues tied to sales taxes and the gaming industry, forcing the state to nearly deplete its reserves, and exposing its reliance on economically-sensitive spending. Up until the 2008 recession though, the U.S. gaming industry had somehow been immune to recessions, so policymakers had, perhaps, grown complacent. Nevertheless, the state responded well to the new reality, which may be seen in the trend of its economic diversification over last two decades[13] (see figure 4).

Figure 4: Nevada Industry Diversification Hachman Index



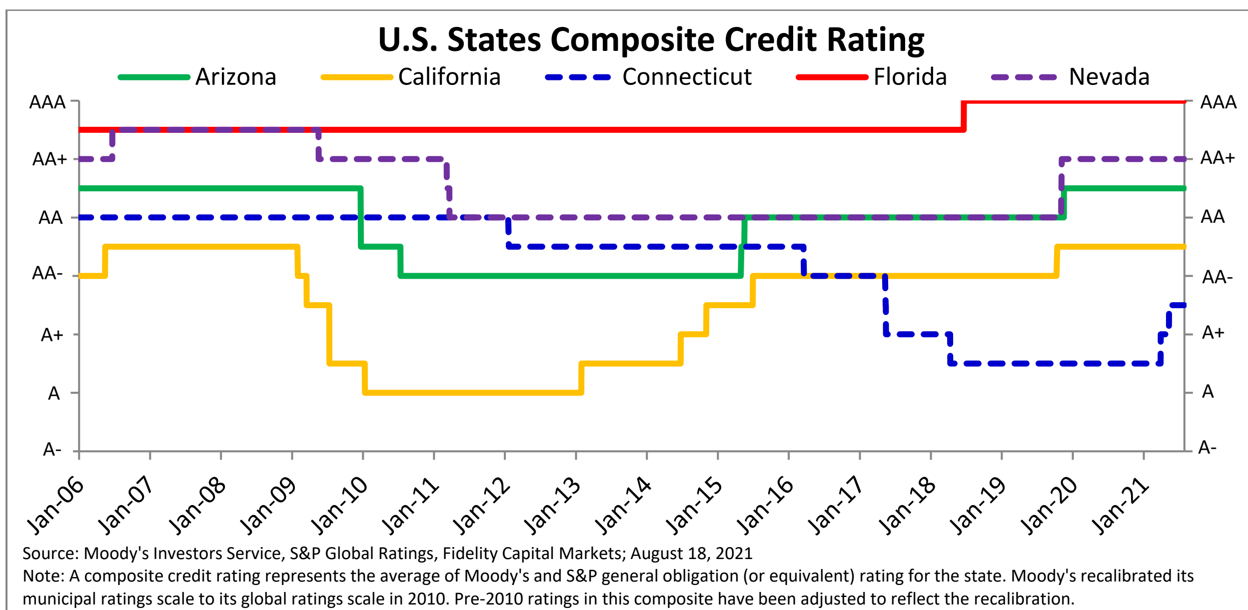
Source: Bureau of Economic Analysis, Fidelity Capital Markets; August 11, 2021

Going into the 2008 recession Nevada had been the fastest growing state in terms of population over the prior two decades. Though the jobs engine of the construction industry had collapsed, the underlying factors driving people to the state remained very much in place: affordability, low taxes, weather, and business climate would largely remain the same going forward and set the state up for an eventual rebound though the exit from recession would be slow.

[13] The measure of a state's overall economic diversity may be derived using the Hachman Index. This is an index of similarity that measures how closely industry earnings of the subject region (Nevada) resembles that of the reference region (United States). The value of the index is between zero and one. As the value of the index approaches one, this means that the subject region's employment distribution among industries is more similar to that of the reference region. If the reference region is the nation, and, given the assumption that the nation's economy is diversified, a larger value of the Hachman Index relative to the nation means that a subject region is more diversified (and therefore less specialized).

Though a 2/3 supermajority requirement to raise taxes places a hurdle ahead of reaching structural budget balance – a hurdle that proved not to be insurmountable given the urgency with which state lawmakers approached the budget process – Nevada benefited from low starting debt levels because of stringent constitutional limits that the state diligently adhered to even as the economy boomed. Even when unfunded pension liabilities are added to its outstanding debt, the state still ranks in the bottom quintile among the 50 states. Nevertheless, it took almost 10 years from the recession's end for the state to see positive rating actions to acknowledge the hard work put in over the prior decade. Proactive budget management during the recession, prudently setting aside reserves during the economic expansion, and adhering to constitutional limits on debt helped stabilize state credit quality and set the state up for an eventual upgrade. It took over 10 years for the state to see upgrades to its credit ratings after the 2008 recession[14]. The aforementioned underlying reasons driving Nevada's population growth reasserted themselves in the decade that followed the recession, driving robust employment gains and helping improve the state financial position. While the state remains exposed to industry concentration, the risks have eased with economic diversification, and consistent structural budget management and strong reserves positioned the state well to confront the pandemic that erupted in 2020.

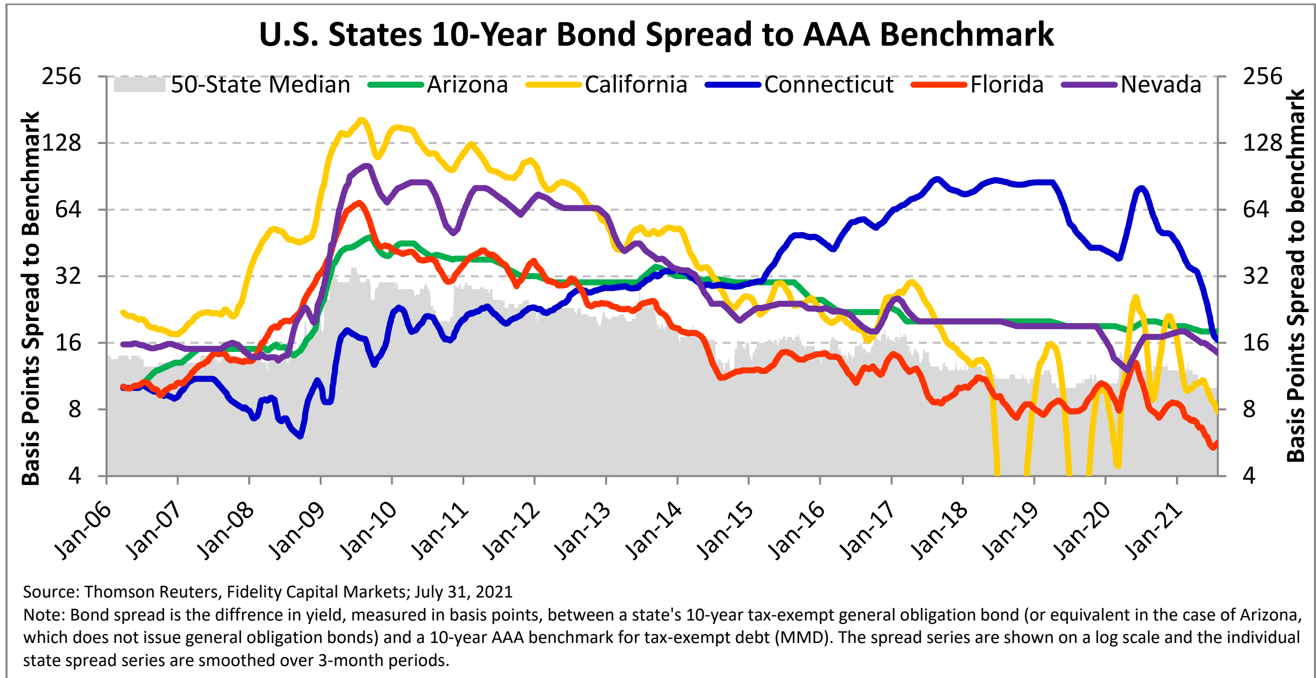
The following charts illustrate the trends since 2006 in the five states' credit ratings and yield premium, or spread, over "AAA" bonds.



Source: Moody's Investors Service, S&P Global Ratings, Fidelity Capital Markets; August 18, 2021

Note: A composite credit rating represents the average of Moody's and S&P general obligation (or equivalent) rating for the state. Moody's recalibrated its municipal ratings scale to its global ratings scale in 2010. Pre-2010 ratings in this composite have been adjusted to reflect the recalibration.

[14] Moody's Investors Service upgraded Nevada to Aa1 from Aa2 on 5 November 2019 and S&P Global Ratings raised its rating on the state to AA+ from AA on 7 November 2019.



Source: Thomson Reuters, Fidelity Capital Markets; July 31, 2021

Note: Bond spread is the diffrence in yield, measured in basis points, between a state's 10-year tax-exempt general obligation bond (or equivalent in the case of Arizona, which does not issue general obligation bonds) and a 10-year AAA benchmark for tax-exempt debt (MMD). The spread series are shown on a log scale and the individual state spread series are smoothed over 3-month periods.

Fidelity Investments
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