September 30, 2018

Dear Shareholder:

The Federal Reserve met on September 26, 2018 and raised the short-term fed funds target rate range an additional 25 basis points to 2.00 to 2.25%. This latest interest rate hike represented the eighth consecutive one-quarter point increase during the current tightening cycle. The market is pricing in four more moves by the Federal Reserve, and this suggests that the end of the rate hiking cycle may be in sight. It's easy to forget, but historically low interest rates have endured for close to ten years now. The low interest rate environment has caused yields to stay stubbornly low and, on the flip side, prices for bonds and bond funds to remain elevated above historical norms.

Over the course of the last year or so, bond prices have gradually declined to more "normal" levels as yields have risen. Lower bond prices manifest themselves in lower net asset values for our bond funds. Investors are generally aware of the inverse relationship between bond prices and interest rates: when one rises, the other falls. However, in reality, the relationship between bond prices and changes in interest rates is more complicated than this.

News about the bond market invariably focuses on U.S. Treasuries, which tend to be the most sensitive to rising rates. However, it's important to keep in mind that the bond market is diverse and is comprised of many different sectors and asset classes such as Treasuries, corporates, high yield bonds, mortgage-backed bonds, and municipal bonds--just to name a few. Each asset class or sector responds differently to economic and market trends and changes in interest rates. In addition to interest rate changes, municipal bond prices are also affected by a wide variety of other variables such as credit quality and supply and demand technical factors. For example, after reaching record holdings in 2017, banks reduced their holdings of municipal debt by $26.7 billion in the first six months of 2018 in large part due to the passage of the *Tax Cuts and Jobs Act*, which reduced corporate tax rates beginning this year. Large scale selling by U.S. banks has led to additional downward pressure on municipal bond prices during the first three quarters of this year.

We are very aware that it can be disconcerting for shareholders to watch the net asset value of a fund in which you are invested decline. We have said it many times, but it is worth repeating: investors are almost always better off staying the course than trying to time the market. It may sound counterintuitive, but if you are a bond investor with a <u>reasonable</u> investment time horizon and some patience, you should actually be pleased that interest rates are *gradually* increasing to more normal levels. In contrast to sudden and large movements in yields (which truly can be frightening and result in losses for short-term investors), a *gradual* increase in yields is a positive development for long-term fixed-income investors. If you are a long-term investor, you should embrace—not fear—higher yields.

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A low yield environment is a form of "financial repression" for fixed-income investors. Low bond yields can be thought of as a tax on savers paid to borrowers, including the government. Remember, interest income is the primary driver of bond returns, <u>not</u> price appreciation. The ability to reinvest into a gradually rising interest rate environment can help build long-term growth in an investment portfolio. When interest rates rise, newly issued bonds pay a higher coupon thereby increasing the income investors receive. An increase in income can help offset the negative impact of falling prices. As interest rates continue to normalize, you should expect to see the yields of our funds gradually rise. This will not occur overnight, but it will happen over time.

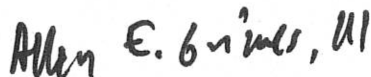
Many people are surprised to learn that municipal bonds have frequently generated solid positive total returns in prior rate hiking cycles. For example, from June 2004 to June 2006 the Federal Reserve raised the fed funds rate a total of 425 basis points during which time municipal bonds delivered an 8.97% total return as measured by the Bloomberg Barclays Municipal Index. Similarly, from March 1988 to February 1989, the Federal Reserve raised the fed funds rate a total of 325 basis points during which time municipal bonds produced a 7.47% total return as measured by the same index. Of course, we would be remiss if we didn't remind you that past performance is not a guarantee of future performance or an indicator of future performance.

We believe it is important to keep in mind that, even though the fundamentals of the bond market change on a daily or even an instantaneous basis, the underlying reasons for investing in fixed-income securities remain unchanged. By investing in high quality bonds that promise to deliver fixed semi-annual interest payments and repayment of principal at a stated maturity, bond funds have historically provided capital preservation, income, and portfolio diversification. All of these are essential goals for most investors.

One of the primary benefits of being a shareholder in our funds is the personal service you receive when you pick up the telephone and speak with someone at Dupree, whether it's an experienced registered representative or even a portfolio manager. We have assembled a seasoned team of professionals who are available to you to discuss current market conditions, fund performance, and any specific details about your account. Please don't hesitate to give us a call.

Thank you for investing with Dupree Mutual Funds.

Sincerely,



Allen E. Grimes, III
President