

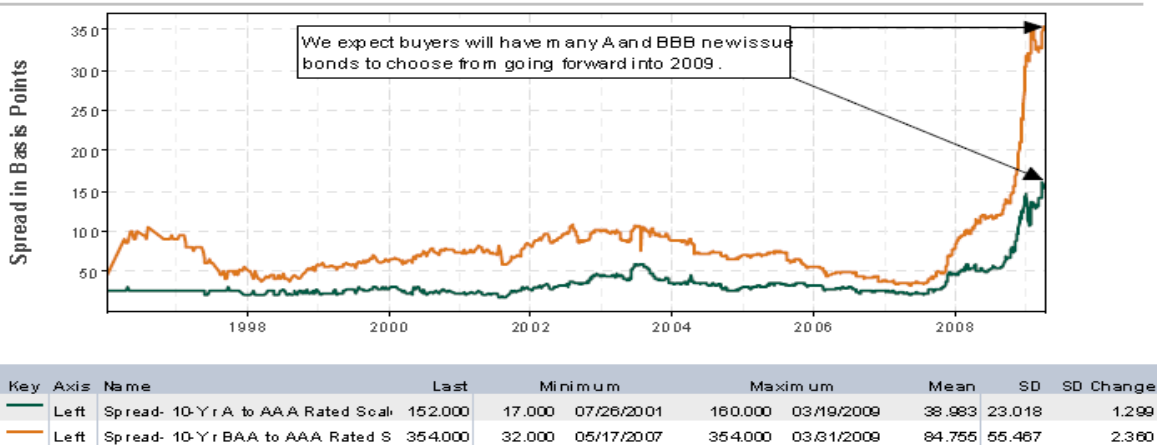
**APRIL 2009**

**Monthly Commentary**

**GDP data for 4Q08 continued to reflect steeper economic declines than previous releases with the latest estimate down 0.1% to -6.3%, while the labor market contracted by more than 600,000 jobs for four consecutive months...**

- **Yields rose in the municipal market in March on a combination of high new issue volume and low yield levels at the end of February.**
- **Supply was elevated in March, as \$38 billion in bonds were sold in the issue market. The volume totaled more than any month since July 2008.**
- **Moody's Investors Service downgraded Berkshire Hathaway Inc.'s insurance subsidiaries, including bond insurer Berkshire Hathaway Assurance Corp., to Aa1 from Aaa. The outlook is stable. The downgrade to BHAC means that Moody's no longer rates any bond insurer Aaa.**
- **Credit spreads on A and BBB rated issuers are quite wide versus high grade yields. These issuers were shut out of the market over the second half of 2008 but should find better levels for their capital in the future as the following graph indicates:**

**Figure 2. Spread of 10y A and BAA Yields to AAA Rated Bonds**



Source: Barclays Capital Municipal Strategies and Index Group



### **The Municipal Market**

Demand from individual investors remained quite solid this month and did not appear to be impaired by the recent improved tone in the equity market. This is an important factor, because non-household sector sources of demand remain extremely limited. In addition fixed-rate supply has actually grown dramatically in 2009 year-to-date. At the current pace, fixed rate issuance should far exceed the \$265 billion of fixed-rate bonds issued in 2008 and possibly come close to the \$320 billion all-time record in 2007. The structure of demand, combined with the heavy fixed-rate issuance noted above and continuing aversion to risk, had a profound effect on yield relationships in the municipal market. The collapse in access to bond insurance and the continuing fear of many individual investors regarding the direction of interest rates adds to shifting yield relationships and results in the following:

- A sharp widening of credit spreads
- A steep yield curve
- A negative credit curve, with credit spreads much wider in intermediate maturities than on the long end.

On 30-year bonds, single A-rated paper yields about 110 basis points more than AAA-rated issues and BAA paper yields about 250 bps more. In contrast, on 10-year bonds, A-rated paper yields 150 bps more than AAA-rated issues and BAA paper yields about 350 bps more according to Muni Market Data-Line. Market participants believe that this negative “credit curve” results from the structure of demand in the municipal market: there are more “yield-hungry” buyers, including open and closed-end bond funds, on the long end and more conservative buyers including direct retail and bank trust departments functioning in the intermediate range. The institutions that buy longer paper tend to be far less credit-risk averse while their counterparts in the intermediate maturity range who tend to be risk averse in terms of both maturity and credit rating as they focus on shorter maturities and AA or better ratings. These factors have helped lead to steep yield curve, wide credit spreads and the negative slope of the credit curve.

Wider credit spreads have the potential to interact with downgrades, when they occur, in an important way: with the wider credit spreads, the market price effect of a downgrading is magnified. Bond issues that have been downgraded to a given rating often trade more poorly than issues that have been stable at that lower rating due to the negative reaction of investors to bonds with falling ratings.

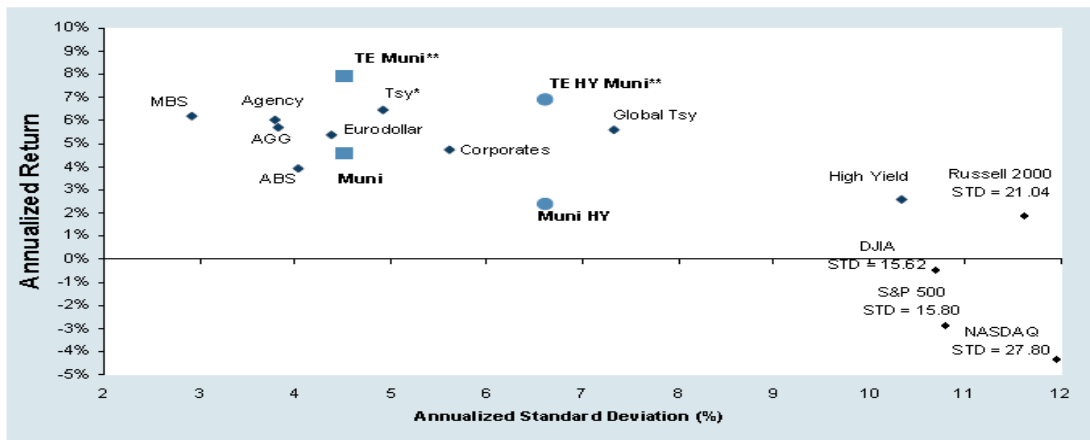
### **The Municipal Yield Curve**

The yield spread between long and short-term maturities on the municipal high grade curve widened in March; the 2s-30s tax-exempt spread increased 20 basis points to end March at 384 bps. The Treasury spread remained relatively unchanged at 276 bps. During the month, yields in the 2-year spot on municipal curve fell the most, by 23 bps, while 10-year yields rose by 6 bps. The Treasury curve saw the 10-year fall by 35 bps, while the 2-year and 30-year sector declined by 17 bps. Going forward, we expect both ends of the yield curve to move slightly higher as increased supply keeps yields higher in the long end and shorter term rates revert to more historical levels.

### Municipals Appear to Have Good Tax-Equivalent Returns over 10-year Horizon

Municipal bonds had one of their best quarterly starts in 2009. The Municipal Index 1Q09 return of 4.22% is the highest first quarter performance it has had in more than 10 years. Not surprisingly, the best first quarter performances within the past 15 years (1995 and 2000) occurred right after the worst annual performances (1994 and 1999). On a trailing 10-year basis, the municipal asset class has provided strong taxable-equivalent returns with lower volatility than its taxable counterparts. As indicated in the graph below the taxable-equivalent returns for the municipal investment grade and high yield indices, as well as the total return of the major taxable fixed income and equity asset classes. The Investment Grade Municipal Bond Index provided the highest taxable-equivalent total return (7.95%) with the High Yield Municipal Index posting the second best (6.87%). The chart also illustrates the volatility of the various asset classes, expressed in terms of the annualized standard deviation of the monthly return series. Investment grade municipals displayed average volatility while maintaining low default ratios.

**Figure 21. Comparison of Taxable Equivalent Returns and Volatility of Municipals and Other Asset Classes (Ten Years Ending March 31, 2009)**



\* U.S. Treasury income returns are exempt from state income taxes and adjusted (3.25% in 2002-2009, 3.23% in 2001, and 3.18% prior) using a national state average (top bracket), net of Federal income tax.

\*\* Based on an equally weighted national average Federal and state (top bracket) income tax rate (38.45% for 2003-2009, 41.85% for 2002, 42.33% for 2001, and 42.78% prior—local taxes have not been considered in the analysis).

Source: Barclays Capital Municipal Strategies and Index Group

### APA's Strategy

We continue to believe that some of the better values exist in the 10-12 year range for intermediate-term investors, where the number of potential types of buyers remains limited and where the slope of the yield curve remains quite steep. Treasury yields fell over the past month, while municipal bond yields rose. After beginning the year with exceptional performance, municipal bonds are likely to backtrack in April, as increased supply leads yields on longer duration issues higher; yields on shorter duration paper may also move higher from near all-time lows.



At APA, our main strategy can be summarized as follows:

1. We continue to favor the barbell strategy as the yield curve remains very steep mainly due to inflationary fears; therefore, we focus both on the short-to-intermediate sector (5 years) and the longer duration bonds since the 10-12-year spot on the municipal yield curve offers considerable roll and liquidity. Our overall duration target remains within the 4-5 years range.
2. We also continue to monitor the credit quality of our holdings vigorously as we buy only issues that have been researched in detail and we feel comfortable holding them for the long term, despite the current recessionary economic environment.
3. We maintain our focus on sectors, local governments and states that are experiencing large budgetary shortfalls due to the economic downtrend and are at risk of downgrade by the major rating agencies.
4. We thoroughly research solid, longer duration A-rated issues and we selectively add positions to our holdings to take advantage of the steep yield curve and the historically wide credit spreads.

### **Costas Kalaitzidis, CFA**

#### **Disclosure:**

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