



Many market participants feel that recent mixed economic data was negatively skewed by bad winter weather. There were sufficient positive elements to boost investor confidence and fuel hopes that the recovery is gaining momentum. Treasury yields continue to rise in anticipation of better economic data in the months ahead...

Overview

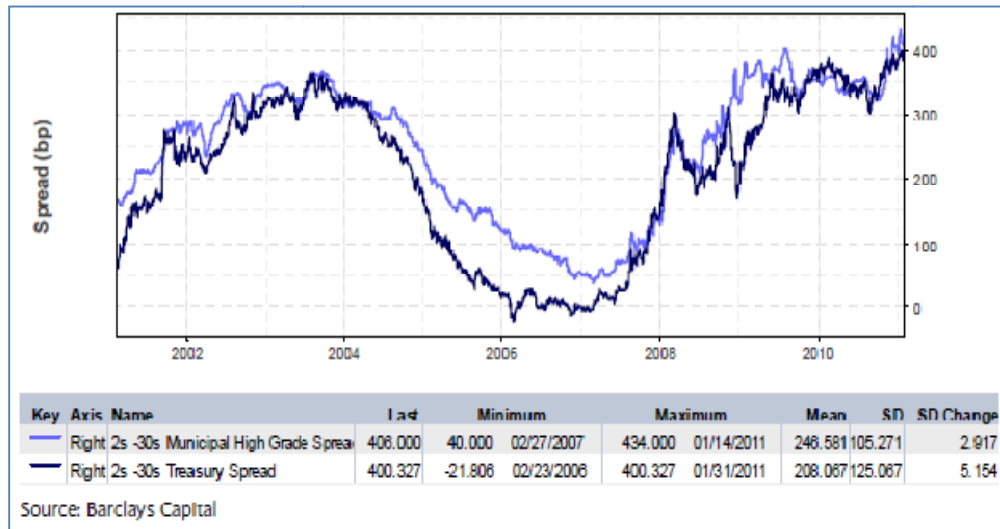
- Recent volatility and uncertainty has given rise to a seemingly attractive municipal market in terms of absolute and relative yields.
- January issuance of \$12.2bn was 62.8% lower than January 2010 supply levels (\$32.7bn) and the lowest volume of any month since January 2000.
- Persistent negative media coverage coupled with surging equity markets continue to drive retail investors away from the municipal market, resulting in 12 consecutive weeks of municipal bond mutual fund outflows.
- We feel projections of an imminent collapse of the municipal market are overblown. When these hyperbolic predictions do not materialize in the upcoming year, we believe investors will once again perceive the municipal bond market as a relatively safe, steady source of tax-free income.

Market Disarray Gives Rise to Attractive Opportunities

Recent volatility and uncertainty in the municipal market has resulted in a record steep municipal yield curve and appears to have created attractive buying opportunities in the high quality municipal bond sector. With the anticipated expiration of the BABs program on December 31, the market became inundated with new issue supply during 4Q10, as many issuers expedited deals originally slated for early 2011 in an effort to take advantage of fleeting tax credits. As a result, January's supply levels of \$12.2bn represented a year-over-year decline of 62.8% and marked the lowest volume of any month since January 2000 (\$9.6bn). In addition, heavy selling pressure spurred by mutual fund outflows has driven bond prices down to levels that we believe offer compelling absolute and relative yields. As the 2-30y

Treasury spread widened to a record 400 bps by the end of month, municipal yields followed suit, trending higher through the first two weeks of January amid large mutual fund outflows before stabilizing towards the end of the month.

2-30y Municipal and Treasury Curve Spread, Ten Years Ending January 31, 2011



According to Barclays Capital, the 2-30y municipal spread reached a 28-year high of 434 bps in mid-January, as relentless negative media coverage on state and local budgetary pressures continued to stifle retail investor demand. Tax-exempt yields increased the most in the 4-6y and 12-19y areas of the curve, rising between 20 and 25 bps. By the end of the month, the 2-30y spread had tightened to 406 bps, as shown in the following table.

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	20 yr	30 yr	2-30y Spread
01/04/2011	0.37	0.72	1.05	1.73	2.67	3.21	3.54	4.47	4.68	+396
01/18/2011	0.37	0.74	1.11	1.88	2.93	3.46	3.85	4.89	5.08	+434
01/31/2011	0.37	0.72	1.10	1.85	2.79	3.31	3.69	4.56	4.78	+406

Source: MMD

In addition, credit spreads for bonds rated below AAA are wider than their respective historical averages across the curve. We believe that opportunities exist in today's market to invest in lower investment grade issues in the 0-3 year maturity range, where the incremental yield on a solid A rated bond vs. a

comparable AAA is 50 – 80 bps. In order to favorably position our clients' portfolios to potentially take advantage of future higher short-term rates, APA currently allocates up to 50% of total portfolio holdings to the 0-3 year maturity range. Meanwhile, we see potential value in AAA and AA rated bonds in the 8 – 12 year maturity range as the steepness of the yield curve approaches near-record levels. We believe the yield curve is particularly attractive in 2018, with potential incremental yield pickup of 33 bps over 2017, versus a one-year average spread of 25 bps.

We currently see encouraging signs of opportunity and lasting stability emerging in our market. The selling in mutual funds appears to have subsided and compelling yields are beginning to spark the interest of crossover buyers who normally invest in taxable bonds. Tax-free municipal bonds are relatively cheap across the yield curve, currently trading at near or over 100% of U.S. Treasuries. At the end of January, the high grade 2yr municipal-to-Treasury ratio was 126.8%; the 5yr was 94.6%; the 10yr was 97.9%; and the 30yr was 104.6%.

Negative Headlines Continue to Overstate Near-Term Budget Problems

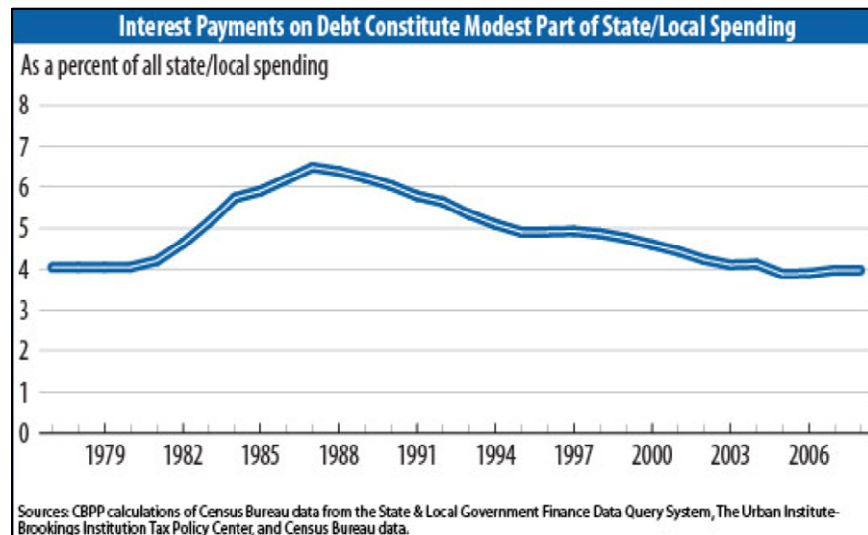
Negative media attention continues to weigh heavily on the municipal market with state and local budgetary pressures under considerable public scrutiny. Investor concerns have been exacerbated by relentless negative municipal headlines, which have played a key role in the negative feedback loop that has plagued the municipal market in recent months. Retail investors are the primary owners of municipal bonds, accounting for more than 70% of the entire municipal market. As a slew of negative media articles instilled fear in the minds of investors nationwide, many investors began selling their municipal investments simultaneously, causing a massive sell-off that weakened the entire market. The sudden surge in supply entered the market at a time of lackluster demand. Negative media coverage has largely contributed to \$36.9 billion in mutual fund outflows over the past 12 consecutive weeks.

While APA acknowledges the fiscal and economic challenges facing many state and local governments, we believe that draconian projections of rampant defaults and the imminent collapse of the municipal market are greatly exaggerated. The most common misconception about the current fiscal problems facing state and local governments is the notion that budgetary pressures will drastically impede the ability to make debt payment obligations. A recent article released by the Center on Budget and Policy Priorities (CBPP), one of the nation's most revered authorities on budgetary issues, explains how fears of widespread municipal defaults are unwarranted and mainly attributed to the generalization of long-term fiscal pressures:

“A spate of recent articles regarding the fiscal situation of states and localities have lumped together their current fiscal problems, stemming largely from the recession, with longer-term issues relating to debt, pension obligations, and retiree health costs, to create the mistaken impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown.”

In wake of unprecedented declines in revenue during the recent recession, state and local governments continue to successfully close current operating deficits by cutting expenditures, implementing new revenue generating practices, and drawing on “rainy day funds” and reserves. Furthermore, in light of increased media attention and criticism, many states have taken steps to address long-term liabilities and underlying structural problems. According to the CBPP, more than 20 states have enacted changes to reduce pension costs in recent years, including raising the length of service and age requirements for receiving a pension, requiring higher employee contributions, and reducing the payout formula that determines the percent of salary that an employee receives as a pension payment for each year of service. Additionally, the recent recovery of stock market values could also ease pressure on funding levels for many states. APA believes many state and local governments will take this opportunity to address more deep-rooted structural flaws in their revenue systems, which if left unresolved, could make it difficult to fund the ongoing cost of public services year over year.

We do not agree with forecasts of massive defaults in the near future, as revenue collections have gradually increased over the past year and the broader economic recovery continues to gain steam. The national unemployment rate decreased to 9.0% in January from 9.4% in December. The ISM non-manufacturing index rose to 59.4 in January, the highest reading since August 2005: new orders rose to 64.9 from 61.4, business activity increased to 64.6 from 62.9, employment increased to 54.5 from 52.6, and the supplier delivery index rose to 53.5 from 51.5. Moreover, according to the Nelson A. Rockefeller Institute of Government, preliminary data for 41 early reporting states show a 6.9% year-over-year increase in revenues in 4Q10. This marks the fourth consecutive quarter in revenue gains and could be the largest rise since 2Q06 if growth is maintained once the final figures are reported. We must also stress that current budget problems cannot be attributed to large outstanding debt payment obligations, based on the fact that debt service accounts for a mere average of 4 to 5 percent of state and local expenditures.



Although we believe that the worst of the negative momentum, panic selling, and headline risk is behind us, we may still face potential periods of market disarray. As a result, APA will continue to focus on high quality general obligation and essential service bonds with secure and well-developed revenue streams.

APA's Strategy

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

1. For new portfolios, given the steep municipal yield curve, we continue to implement a barbell strategy by targeting the following yield curve segments:
 - 50% of total holdings allocated to 0-3 years in maturity.
 - 50% of total holdings allocated to 8-12 years in maturity.

In addition, we do not see a long-term threat from significantly higher inflation. We feel that the current moderate uptick in inflation is mostly driven by the cyclical nature of commodities. Moreover, we do not project further inflationary pressure in the near-term, as prolonged high unemployment rates continue to suppress labor costs. Our overall duration target remains within the 4.00-5.00 year range.
2. While geographic exposure weightings vary from state to state, based on the investor's tax profile and state of residence, we recommend investors in high tax states diversify among issuers within their state of residence, while those in lower tax states may look for greater diversification in out-of-state issues. Currently, investors can take advantage of the steep municipal yield curve to make up the tax on out-of-state bonds by extending maturity just a

- year or two on out-of-state issues.
3. We believe that we are well positioned to capture additional yield by investing in market sectors where credit spreads remain wider than historical averages. Examples include water & sewer bonds, highly rated hospital bonds, state housing authorities, public power authorities and public school district debt in states that offer an intercept program which should bolster diversification and price stability in our portfolios.

Disclosure:

Past performance is not indicative of future results. This material is not financial advice or an offer to sell any product. The actual characteristics with respect to any particular client account will vary based on a number of factors including but not limited to: (i) the size of the account; (ii) investment restrictions applicable to the account, if any; and (iii) market exigencies at the time of investment. Asset Preservation Advisors, Inc. reserves the right to modify its current investment strategies and techniques based on changing market dynamics or client needs. There is no assurance that any securities discussed herein will remain in an account's portfolio at the time you receive this report or that securities sold have not been repurchased. The securities discussed may not represent an account's entire portfolio and in the aggregate may represent only a small percentage of an account's portfolio holdings. It should not be assumed that any of the securities transactions, holdings or sectors discussed were or will prove to be profitable, or that the investment recommendations or decisions we make in the future will be profitable or will equal the investment performance of the securities discussed herein.

Asset Preservation Advisors, Inc. is a registered investment advisor. More information about the about the advisor including its investment strategies and objectives can be obtained by visiting www.assetpreservationadvisors.com.
APA-11-42