

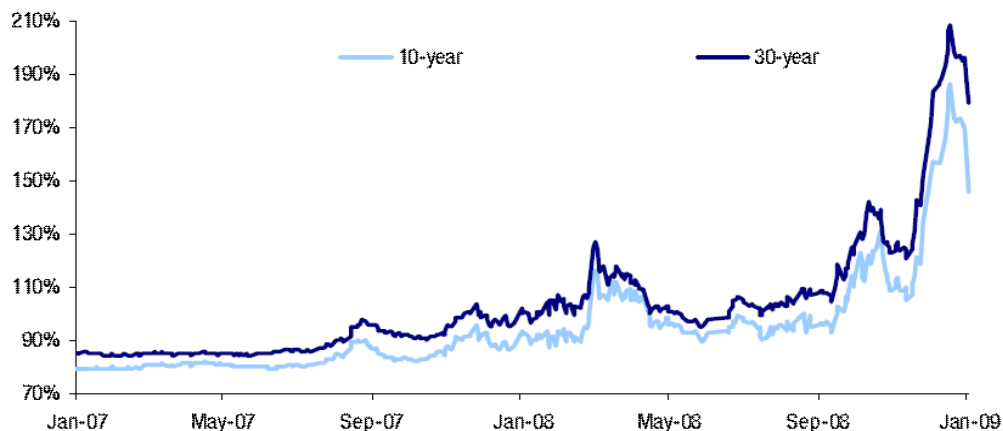
JANUARY 2009

Monthly Commentary

A slowing economy and aggressive macro strategies employed by the Federal Reserve Bank and the Treasury have lowered a wide range of fixed income yields and narrowed credit spreads...

- The municipal market experiences a significant rally during the first two weeks of January with dramatically lower yields.
- Narrowing spreads in other markets and the expectation of federal assistance for the states has improved the posture of municipal bonds.
- The sense of panic which pervaded the municipal market in mid-December has subsided as it became clear that fears regarding the likelihood of payment defaults on state debt may have been overstated.
- We continue to emphasize disciplined investing with a focus on high quality essential purpose municipal bonds.
- Municipal bonds remain relatively cheap to Treasury with ratios around 140% to 160% across the yield curve as the following graph indicates:

Figure 2. Ten- and 30-year Munis as a Percentage of Treasuries, Jan 07 to Jan 09



Source: Citi



The Municipal Market

In early to mid December the municipal bond market was in severe distress, sending yields on even the best quality bonds to extraordinary levels by historical standards. However, everything changed in January as yields declined rapidly and across the board. For example, yields declined roughly 130 basis points in long-term paper insured by FSA and Assured Guarantee. Also, yields on AA and A-rated hospitals and power authorities declined 120 basis points while yields on essential revenue bonds dropped by 100-110 basis points. It appears that a number of factors breathed life back into the municipal bond market:

- 1. Federal support to state and local governments.** It is clear that state and local governments would participate heavily in the ultimate stimulus package enacted by Congress. Even though the Fed and Treasury had been reluctant to directly assist state and local governments initially, that appears to have changed with the new Administration. Specifically, states are expected to receive substantial Medicaid assistance and aid for infrastructure from the next stimulus bill. Also, block grants for clean water and other purposes have been discussed. Therefore, the passage of the stimulus bill may significantly improve the near-term credit profile of the states.
- 2. New institutional buying.** Many crossover buyers concluded that municipal bonds were too cheap relative to taxable bonds and moved into the municipal sector to capture a total return opportunity.
- 3. Yield on cash equivalents is quite low currently.** As short-term yields continue to decline the prospect of much higher yields on high quality municipal paper 10 years and shorter cannot be overlooked. Yields on 7-day variable rate notes dropped to 0.59% this month from 1.00% range in early December.
- 4. An improved fixed-income market tone, away from Treasuries.** Almost all spread product sectors including high yield corporate bonds have rallied, both in absolute terms and in comparison with Treasuries.
- 5. The likelihood of a full-blown default crisis in the municipal sector remains very low.** There is growing understanding that municipal credits do not move rapidly into default even under severe economic circumstances. States simply cannot file for Chapter 9 bankruptcy protection. According to rating analysts even in the current steep economic downturn, all 50 U.S. states remain solid investment-grade credits.

The Municipal Yield Curve

The municipal curve flattened in December. Since the end of last year, the tax-exempt and Treasury spreads have increased by 181 basis points and 52 basis points respectively. At the end of December the 2s-30s tax-exempt spread decreased 9 basis points, reaching 316 bps, while the Treasury spread fell 57 bps, reaching 191 bps. During the month, the tax-exempt curve, shifted down by 25 bps in the 2-year sector and 34 bps in the long end (30-year). The Treasury curve has displayed a similar dynamic as both the 2-year and 30-year sectors moved down by 23 bps and 80 bps respectively. Several market participants expect the front end of the municipal curve to trend lower in the short-term. Liquidity provided by the Federal Reserve Bank and capital injections by the Treasury contributed to a decrease of the yield levels in the broader markets. These measures, coupled with the announced federal assistance



to states as part of the economic stimulus package, should help to alleviate uncertainty in the municipal market and decrease the municipal yields.

The Municipal Bond Supply

December supply of \$20.2 billion was 29.7% lower than last year's supply of \$28.7 billion. There was little institutional demand during the holiday season and less need for tax-exempt income with the global recession. Demand from retail buyers continues to be the main source of support in the primary market. 4Q 2008 issuance of \$68 billion was 34% below 4Q 2007 levels. Long-term bond supply for 2008 is \$386.6 billion or 8.9% lower than last year's supply of \$3.96 billion. Refunding of \$108 billion is 43.2% higher than last year's of \$75.5 billion because of the auction rate securities conversion over the year. From a sector perspective, the environmental facilities sector had the largest year-to-date increase of 52% with \$7.4 billion in bond issuance. The healthcare sector had the largest dollar amount increase of \$11.8 billion. For 2008, California has issued \$52.4 billion in bonds, the largest among state issuers but 20.2% lower than last year. Texas and New York have issued \$40.7 billion and \$40.1 billion of bonds year-to-date, respectively ranking second and third. Going into 2009, most market participants expect total issuance to be about 15% lower than last year, or approximately \$350 billion.

APA's Strategy

Underperformance in the equity markets and uncertainty about the length and severity of the current recession has driven some individual investors towards investments into the municipal sector. The relative high quality of municipal cash flows has facilitated a long history of reversion to the mean following periods of distress. Throughout 2008 municipals cheapened significantly relative to Treasuries. The ratio between 2-year high grade municipal and Treasury yields reached historical highs, from 96.8% at the beginning of 2008 to 232.1% at the beginning of January 2009. The 10-year and 30-year ratios followed suit, increasing from 90% to 141% and from 96.9% to 165.8%, respectively. At APA our main strategy can be summarized as follows:

1. We continue to focus mainly on the short-to-intermediate sector (5 years) along with strong credit quality but we are also gradually moving to a more barbell strategy. Some of the best values on a risk-reward basis are in the 10-15 year maturity range, where the slope of the yield curve remains extremely steep.
2. Diversification by state and sector is more important than ever, especially in states we see as having severe budgetary challenges.
3. Essential service revenue bonds can be an important component of a diversified portfolio and after a comprehensive credit analysis we may add them to our portfolios as market opportunities become available.
4. We continue to favor bonds that are insured by the stronger rated bond insurers while we thoroughly check the underlying credit quality of all of our holdings regardless of insurance coverage.

Costas Kalaitzidis, CFA

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