



Ongoing geopolitical unrest and ensuing concerns about rising energy costs seem to have driven investors to the safety of U.S. Government debt over the past few weeks. Global economic volatility is to be expected in upcoming months as political turmoil continues to afflict parts of the Middle East and North Africa, and the world grieves over the devastating loss of lives and destruction in Japan.

Overview

- After months of declines, municipal bonds outperformed their U.S. Treasury and corporate credit counterparts in February.
- The municipal market has benefited from several factors including the current short-term technical supply/demand imbalance, considerably light new issue supply, and increasing support from crossover investors.
- Municipal mutual fund outflows have dramatically declined, as dire predictions about municipal defaults remain purely speculative and have garnered much opposition from market experts.
- Fundamentals appear to be improving in the municipal market; tax revenues are gradually increasing and state and local governments continue to slash expenditures and reduce inefficient spending.

Diminished Supply Triggers Month Long Municipal Rally

Municipal bonds posted positive returns after five consecutive months of declines, as the market benefited from several favorable underlying trends: record-low new issue supply, increased crossover investor demand, a steep decline in municipal mutual fund outflows, and downward trending defaults. The municipal market rallied from mid-January lows as a lack of new issuance and continued interest from crossover investors bolstered prices in February. The Merrill Lynch 1-12 Year Municipal Index returned 1.06% in February, with the 8- to 12-year sector experiencing the greatest appreciation in prices within the index.

	1 yr	2 yr	3 yr	5 yr	8 yr	10 yr	12 yr	15 yr	20 yr	30 yr
1/18/11	0.37	0.74	1.11	1.88	2.93	3.46	3.85	4.32	4.89	5.08
1/31/11	0.37	0.72	1.10	1.85	2.79	3.31	3.69	4.13	4.56	4.78
2/28/11	0.38	0.71	1.06	1.76	2.52	2.97	3.39	3.84	4.26	4.69
Change	+1	-3	-5	-12	-41	-49	-46	-48	-63	-39

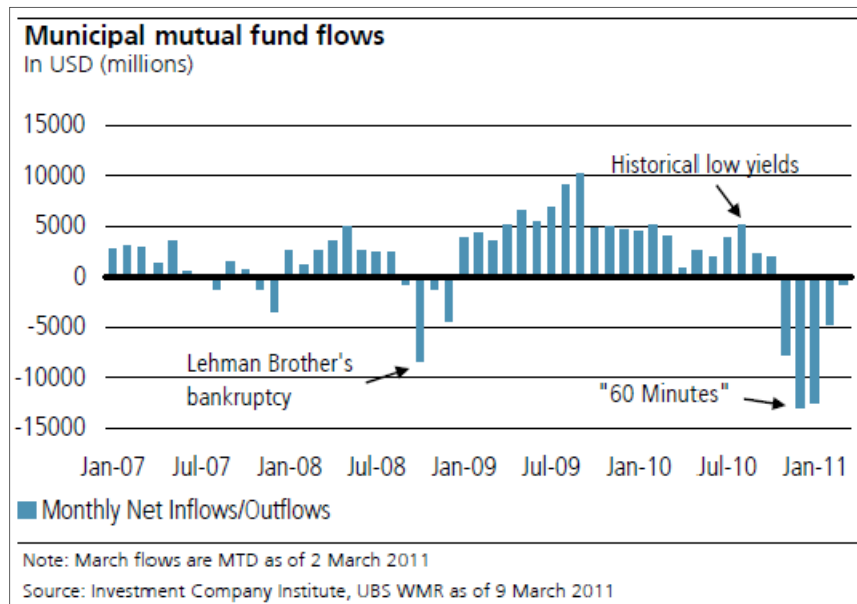
Source: MMD

February 2011 Performance		
	Merrill Lynch Municipal Index	U.S. Corporate Index
AAA	1.31%	0.31%
AA	1.64%	0.48%
A	2.12%	0.73%

Source: Bloomberg

Municipal bond issuance is currently on pace for its lowest quarter in over a decade. As of March 4, year-to-date issuance was a mere \$31.5 billion, marking a 52% year-over-year decline. The last time new supply was lower over the same time period was 11 years ago, when issuance totaled \$25.1 billion. The lack of new issuance can partially be attributed to the expiration of the BABs program at the end of last year, when deals originally slated for early 2011 were rushed to market during the final months of 2010 in an effort to take advantage of the government subsidy program. In addition, many states are delaying bond sales in a continuing effort to curb government expenditures. For example, Governor Jerry Brown of California, the municipal market's largest issuer of debt, imposed a moratorium on bond sales until fall 2011, marking the first time since 1988 that the state will not come to market in the spring.

Although the recent rally pushed municipal yields to their lowest levels relative to Treasuries since last September, municipal-to-Treasury ratios remain favorable and above historical percentages, drawing increasing demand from non-traditional investors. Crossover investor demand helped offset another month of continuous, yet much lighter, municipal mutual fund redemptions. Mutual fund flows tend to mirror the direction of the overall municipal market and serve as good indicators of investor confidence, strengthening during rallies and contracting during dislocations. Muni mutual fund outflows plummeted to \$4.4 billion in February following outflows of \$12.5 billion in January.

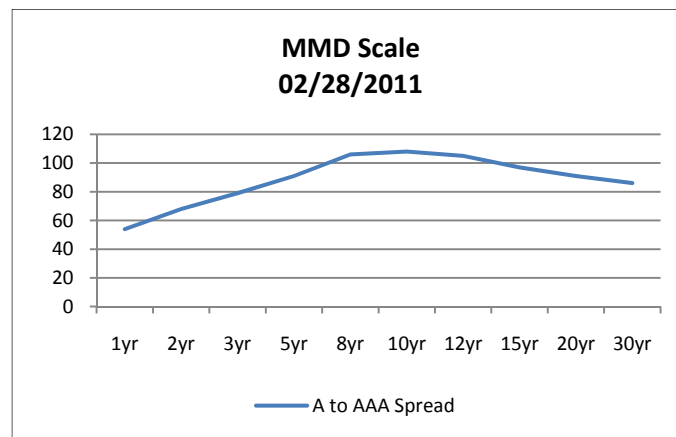


Dire Predictions Begin to Lose Credibility

Another month, another round of negative media coverage targeting the municipal market, though it seems even those who are bearish about the muni market are casting doubt on Meredith Whitney’s dire prediction of 50 to 100 sizeable defaults totaling “hundreds of billions” of dollars. The latest report comes from consulting firm Roubini Global Economics LLC, which forecasts \$100 billion in defaults over the next five years. In the report, their projection is stated to be a “pessimistic calculation” and that of the amount, investor losses would total only roughly \$35 billion because of the historically high rate of principal repaid on distressed municipal bonds. Even though Roubini’s projection is drastically lower and therefore more reasonable when compared to Whitney’s, we still believe the firm’s prediction to be extreme based on historical evidence. In a recent report, seasoned analyst Chris Mier applies mathematics based on historical default trends to both Whitney and Roubini’s projections of municipal defaults. According to his findings, in order for Meredith Whitney’s projection to occur, the largest 50 cities in terms of debt outstanding would have to default, totaling a mere \$83 billion, followed by *several* large states – i.e. California with \$87 billion, Illinois \$24 billion, Michigan \$7 billion, and New Jersey \$32 billion. In the near impossible event that those defaults did indeed occur, the total value would be approximately \$233 billion. Mier’s calculation alone should quash any fear of Whitney’s projection becoming reality.

Mier goes on to examine Roubini’s projection of \$100 billion over a shorter-than-projected 3-year span. Using the former rating system that does not reflect current global ratings, which he believes removes too much relative credit information, Mier constructed a 3-year default scenario for each rating category. Based on his calculations, \$100 billion in defaults over a three year period would require a 50% default rate on *all* non-investment grade bonds. In addition, for Roubini’s figure to be accurate, 5% of Baa-rated bonds and 3% of A-rated securities would need to default. To put into perspective, a 5% default rate on Baa-rated bonds is **1851x the 30-year historical rate from 1970 to 2000**. Moreover, a 3% default rate on A-rated bonds is **2000x the 30-year historical rate**. As Chris Mier’s calculations so clearly illustrate, the probability is negligible for municipal defaults to reach these critics’ projections.

Although APA believes fears of significant default are unwarranted, we continue to stress the critical importance of credit analysis in the current market environment. Due to recent media coverage, bond prices are reflecting sharper distinctions in credit quality, allowing high-quality municipals to strengthen to a much greater degree than medium or low-rated bonds. The graph below shows the spread between the A and AAA MMD Scale on 2/28/11. Spreads are the widest in the 8- to 12-year sector at over 100 bps.



Source: MMD

An important aspect of the municipal market is the correlation between bond prices and trade activity. The more frequent a bond trades, the better the bond price reflects actual market conditions. Since the bond market is not as transparent as the equity market, this can weaken bond values in some cases, but also allow investors to take advantage of price inefficiencies in the secondary market. According to a recent report by J.P. Morgan, of the current 50,000 active issuers in the municipal market, 1% of them

are responsible for 64% of the muni market's dollar value. To put this in a better perspective, the overall municipal market is currently valued at roughly \$3 trillion, with the top 500 issuers accounting for nearly \$2 trillion, and the remaining \$1 trillion coming from the other 49,500 issuers. The top 500 issuers include well-known names that tend to issue bonds frequently such as the states, cities and established municipal transit and essential-service authorities. High grade and transparent credits issued by these municipalities appear to be in top demand, especially when issued with high, defensive coupons of 5% or greater. APA favors these issuers for the following reasons: they are under continuous review by rating agencies and credit analysts, bond prices tend to better reflect current market conditions, and top demand translates into tighter bid-ask spreads and therefore better liquidity.

Market Forecast for the Foreseeable Future

Municipals reversed a 5-month long downturn in February, posting gains across the yield curve. As described above, many underlying factors can be attributed to the recent rally, but probably the most important aspect going forward is retail investor demand. APA believes the recent rally will come under pressure in the upcoming months as new issuance begins to pick up. Increased demand from crossover buyers continues to support the market, but it is yet to be seen if this additional source of demand will be able to carry a heavier new-issue calendar. In order to effectively absorb a future increase in issuance, we believe current crossover demand must be matched by an increase in retail demand. Favorably, fundamentals seem to be gradually improving in the municipal market as states continue to make progress in managing budget deficits, and defaults continue to trend lower. States are successfully closing current operating deficits making unrelenting cuts, implementing new revenue generating practices, and drawing on rainy day funds and reserves. Furthermore, numerous states are addressing their long-term debt obligations by initiating pension reform and hardening their negotiating stance with civil service unions. For example, Wisconsin Governor Scott Walker recently announced plans to terminate collective bargaining agreements, while also increasing public employee contributions to pension plans and doubling their healthcare premiums.

As dire predictions of a muni market collapse continue to lose both steam and credibility, we believe investor confidence will improve and retail demand in both separately managed accounts and municipal mutual funds will pick up. Contrary to "self-proclaimed experts", municipal bond defaults in the first two months of 2011 are down 50% year-over-year according to Standard & Poor's.

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 to 5.00 year range.
2. We recommend investors allocate a portion of their portfolios to out-of-state bonds, even in high-tax states, in order to increase geographical diversification and help mitigate concentration risk. 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.

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