APA ASSET PRESERVATION ADVISORS

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Monthly Commentary

The economy and financial markets remain in an accelerating downturn as the labor market is indicating a deep and prolonged recession. While inflationary risks seem to be dissipating rapidly, the Fed officials focus on providing more accommodating financial conditions…

- **Liquidity in the municipal bond market has improved from the historical dislocation experience over the past six weeks. High liquidity can be found in pre-refunded and state general obligation bonds.**

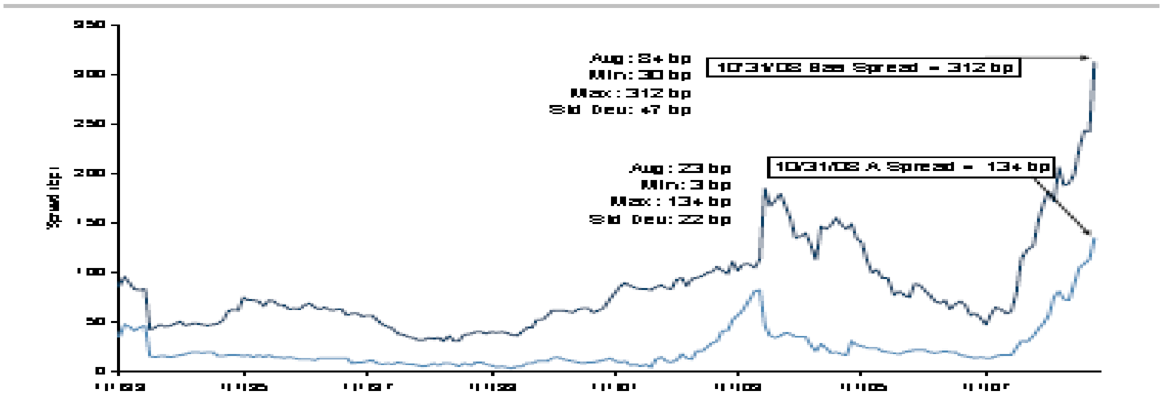
- **A strong case can be made that municipal bonds are still inexpensive all along the curve. Triple-A muni yields as a percentage of Treasury yields remain high (110% in the 10-year maturity bracket).**

- **A new bond insurer has been licensed to write financial guaranty policies for municipal bonds. Municipal and Infrastructure Assurance Corp., (MIAC) is sponsored by the MacQuarie and Citadel Investment Group.**

- **The new administration's tax policy will likely increase the attractiveness of municipals due to the increase of the top marginal effective tax rate and higher taxes on capital gains and dividends.**

- **The spread between the Aaa-rated municipal bonds and A/Baa bonds are at record levels (see graph):**

Figure 3. Baa and A Municipal Index Spread to Aaa Municipal Index



Source: Barclays Capital Municipal Strategies and Index Group.

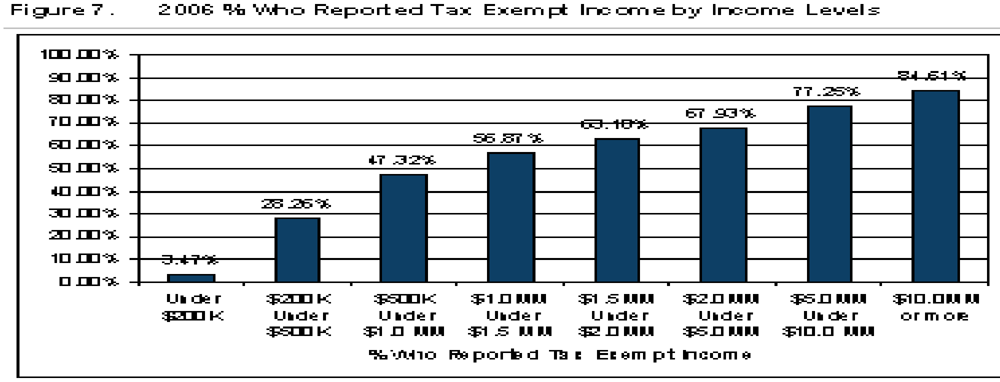
The Municipal Market

Over the past six weeks, the municipal market has seen more change, pressure and overall volatility than most normal years in recent history. While liquidity has improved in October, demand is far from typical levels and volatile conditions are expected to persist through year-end. Additionally, continuing the trend that began in the summer of 2007, municipal bonds as well as other fixed income securities have underperformed Treasuries YTD, as risk aversion has continued to guide investors' allocation strategies. Municipal rates rose over 100 bps in mid-October, when the 30-year muni yield reached an 8-year high. Municipal-to-Treasury ratios hit 142% on October 15th, an all time high. Though ratios have been +100% for most of the year, the dislocation in October reached unprecedented levels. Municipal bonds should trade at absolute lower yields than Treasuries, given that their income is tax-exempt to U.S. taxpayers. When municipal bond yields trade at higher absolute yields vs. equal maturity Treasuries, an investor is effectively getting that tax exemption for little or no cost. As mentioned in the last month's commentary, we think the sell-off in the municipal sector has been **liquidity-driven** and not credit-driven. Illiquidity that was initially driven by the lack of interest from the broker/dealer community and then exacerbated by massive hedge fund selling, was further augmented by the fear and uncertainty in the market at the end of September.

New Tax Policies Will Likely Boost the Attractiveness of the Municipal Sector

Many market participants expect the change at the executive branch and in Congress will result in higher taxes for core municipal investors. The President and Congress could compose new legislation to raise taxes for higher wage earners or simply do nothing and allow the Bush tax cuts to expire at the end of 2010. The new administration plans to extend the 2001 tax cuts for the 10%, 15%, 25% and 28% tax bracket income groups but raise it to 36% and 39.6% from the current 33% and 35% for the over $200,000 and $250,000 income groups respectively. Therefore, increased interest in tax-exempt bonds will likely result from raising the income tax for the wealthiest percentages of the population. As the following graph indicates, for the tax year of 2006, only 3.47% of individuals with income less than $200,000 reported tax-exempt income while more than 54% of the investors who had incomes of $500,000 or greater reported tax-exempt income. When the tax rate of the high income investor rises, the taxable equivalent return on municipal securities usually increases, as does their relative attractiveness.

Figure 7. 2006 % Who Reported Tax Exempt Income by Income Levels



Source: U.S. Internal Revenue Service

The Municipal Yield Curve

The 2s-30s tax-exempt and Treasury spreads increased during October. At the end of the month, 2s-30s tax-exempt spread increased 12bps, to 288 bps, while the Treasury spread increased 48 bps, to 279 bps. Since the end of last year, the tax-exempt and Treasury spreads have increased by 153 bps and 140 bps respectively. In the tax-exempt world, the municipal curve shifted down by 1 bps in the 2-year sector and up 11 bps in the 30-year of the curve. The Treasury curve displayed a similar dynamic as the 2-year moved down 42 bps and the 30-year sector increased by 6 bps. Going forward, the measures undertaken by the Federal Reserve Bank to ease liquidity by expanding its lending program and further decreasing its benchmark interest rate as well as the capital injections by Treasury should contribute to a reduction in the yield levels. However, market participants believe that tax-exempt spreads may go higher in the long end of the curve, as the worsening of state fiscal conditions could increase new municipal supply and limit transactions in the secondary market.

The Municipal Bond Supply

October supply of $20.6 billion was lower by 54% than last year's record for October of $45 billion. As institutional demand including insurers, mutual funds and TOB programs faltered and municipal mutual fund redemptions increased, yields rose higher than we have seen in eight years in the first half of the month. Issuance from the 5th to the 18th was only $7.2 billion. However, strong demand from retail buyers in the fourth week drove yields down and issuers brought deals to the market. Year-to-date long-term bond supply is $339 billion, or 7.34% lower than the $366 billion last year. Refunding at $97.4 billion is 41.4% higher than last year at $68.9 billion largely due to the auction rate securities conversion. From a sector perspective, the environmental facilities sector had the largest year-to-date increase (79% or $2.7 billion) in bond issuance. The healthcare sector has the largest dollar amount increase ($10.2 billion). Year-to-date California has issued $49.9 billion of bonds, the largest state issuer but 16.8% lower than the same period last year. Texas has issued $35.9 billion of bonds year-to-date, ranking second on the list. Its bond issuance increased 3% from last year.

APA's Strategy

In our view, the municipal sector is currently one of the most attractive asset classes in fixed income for conservative investors with longer-term time horizons. Unusually high absolute municipal yields and relative value relationships offer unique opportunities to individual investors, especially when the municipal credit fundamentals have remained relatively stable throughout this year's liquidity crisis. At APA, we believe that the Federal Reserve Bank will likely continue its accommodating interest rate policy given the economy's weak state. However, considering how cheap municipals have become relative to Treasuries, we expect that municipal bonds will outperform Treasuries over the near term and should be well-positioned over the coming quarters. Finally, we continue to focus on high quality bonds for our managed portfolios as sufficient liquidity and capital preservation remain our most important goal. Underlying credit quality ratings have become substantially more important over the past few months as the presence of insurance is sometimes meaningless or even harmful to the bond's market value.

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