



MARKET COMMENTARY

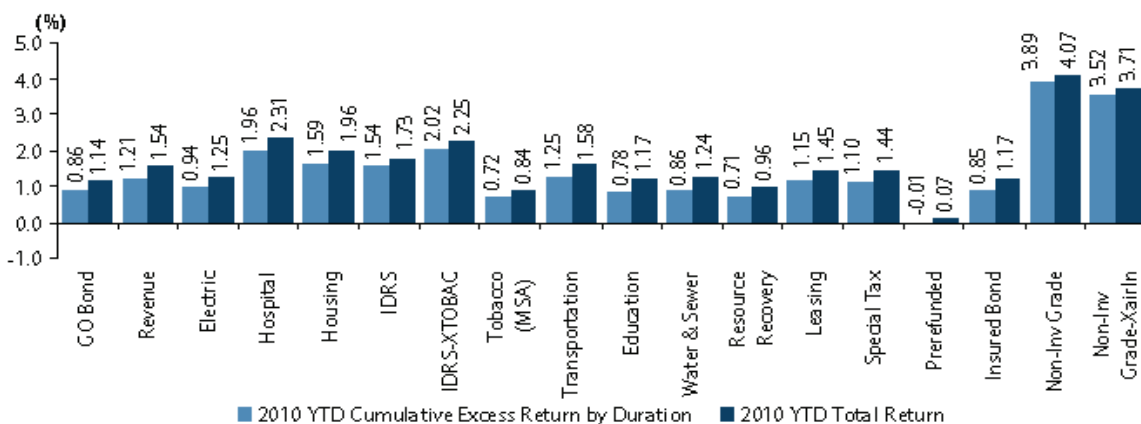
April 2010

The economy showed signs of improvement during March, with payrolls expanding by 162,000 as businesses continue to hire to meet increasing demand. Economists believe that improved labor market conditions, coupled with higher equity market valuations will lead to increased consumer spending...

Overview

- Since mid-March, municipal yields have moved higher, while the high-grade municipal yield curve flattened considerably.
- The intermediate municipal yield curve, particularly in the 2 to 5-year portion, has come under pressure for a number of reasons, including the unsustainably low yields as a percentage of Treasury yields.
- Moody's and Fitch announced that they will recalibrate their U.S. municipal bond ratings to global rating scales throughout April, 2010.
- Municipal bond issuers have sold \$32.7 billion of taxable debt in the primary market over the first quarter of 2010. Excess returns in this sector continue to impress as spreads begin to tighten from their relatively wide levels.
- As the graph below indicates, high yield tax-exempt bonds have produced sizable excess returns of 3.89% thus far in 2010. The sector tightened considerably during March as investors sought to pick up additional income to offset the low yields in the investment grade area of the market.

Figure 3: 2010 Year-to-Date Excess and Total Return Ending March 31, 2010



Source: Barclays Capital



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The Municipal Market

Yields in the municipal bond market have moved significantly higher (20-35 bps) since mid-March, except on the long end as the following table shows:

AAA GENERAL OBLIGATION YIELDS

Date	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	30-yr
03/12/2010	0.25	0.77	1.42	2.18	2.80	3.02	3.32	3.78	4.15
04/01/2010	0.32	1.10	1.77	2.53	3.10	3.30	3.51	3.84	4.17
Change in bps	7	33	35	35	30	28	19	6	2

Source: Thomson Reuters MMD

The rebound in municipal yields results from a number of factors:

1. High grade municipal yields on shorter intermediate maturities reached unsustainably low levels, both in absolute terms and as a percentage of Treasury yields; in fact, no significant value in the 1 to 5-year portion of the municipal yield curve was apparent. Sharp declines in value resulted as investors flocked into shorter intermediate municipal bonds from near-zero yielding short-term instruments, especially money market funds.
2. Weaker flows into intermediate term municipal funds. These weaker flows came after more than a year of consistent, very strong flows that led to record inflows throughout 2009. During volatile periods, bond fund flows tend to generate their own momentum. Lower yields in the municipal market generate stronger flows, which put downward pressure on yields; higher yields in the municipal market tend to generate weaker flows, which put further upward pressure on yields.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) tightened 21bps during March, as long-term yields remained relatively unchanged, while the short end of the curve rose. Yields in the short and intermediate portion of the curve rose 20-30 bps. The 10-30 year high grade spread tightened 24 bps, to end the month at 108 bps. The Treasury curve tightened slightly in March. The 2-30 year Treasury spread tightened by 4 bps to 369 bps, as 2-year yields rose 20 bps and the 30-year rose 16bps. Treasury yields recently rose in response to positive economic news on unemployment and manufacturing reports, which have shown signs of the recession's possible end. Rising Treasury yields and a flattening curve reflect a stable economic outlook with sustained growth. The municipal



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curve is likely to flatten from its current steep level and gradually revert closer to its 10-year historical average of 221 bps.

Moody's and Fitch Recalibration Effect on Municipal Yields

Both Moody's and Fitch have announced plans to "recalibrate" state and local government ratings. The shift in ratings criteria will align municipal rating standards with those established for corporate debt, sovereign debt and local governments. The revision comes after many years of lobbying by elected officials who were concerned that municipalities were paying elevated interest costs on their debt because the agencies held them to higher standards than other asset classes. Fitch announced the rating recalibration for all state obligations on April 5. At the state general obligation (GO) level, ratings were increased by a single notch except for the two lowest-rated states, California and Illinois. California was increased by two notches from BBB to A-; Illinois was increased by two notches from A- to A+. Fitch is also upgrading water & sewer and public power issues. Bonds with A+ or better will receive one notch increases, while A through BBB-rated bonds will receive two notch upgrades. Appropriation-backed debt between AA and A ratings will receive a one-notch upgrade and two notch upgrades from A- to BBB-. Special tax bonds below AAA will receive a one-notch upgrade, as will public higher education bonds below AA. Similarly, Moody's will upgrade municipal bonds to match its global rating scale. The largest effect will be seen on lower rated GOs, water & sewer and utilities. Baa1 through Baa3 bonds in this category will receive two or three notch upgrades. Most investment grade special tax, mass transit, non utility enterprises and public university bonds will be upgraded one notch. Healthcare, private universities, infrastructure enterprises, power generating utilities, bond banks and federal leases will not receive upgrades.

Market participants expect modest changes in yield levels for most credits. Fitch's changes of two notches will be limited to GOs, water and sewer and power distribution issues currently rated single-A or below. Issuers receiving a two-notch increase may see a moderate reduction in their yield levels, while the market impact should be quite modest for issuers receiving a one-notch increase. Moody's recalibrations exhibit a greater magnitude. In certain cases, GOs, water and sewer, distribution utilities and municipal utility districts in the Baa3 range could, on average, increase 2 to 3 notches and those bonds in the Baa2-Baa1 could on average receive 3-notch increases. Thus, a Baa1 issue in these categories could now be A1 and a Baa2 issue will be A2, on average. These significant shifts in ratings could improve trading levels for the affected issues. Similar to the Fitch recalibration, issues in the A3 – A1 categories could be increased by 2 notches on average and those bonds of Aa3



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or above will be increased one notch. Standard & Poor's ratings are not being recalibrated at present. Ratings in a number of categories have been increased over time as a result of criteria changes. S&P is claiming that it already uses global scale criteria for all of its ratings.

APA's Strategy

We continue to focus on high quality general obligation and essential service revenue bonds from larger and established issuers. We prefer bonds with clearly identifiable sources of revenue backing their payments.

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

1. For new portfolios, we continue to employ a "barbell" strategy by investing into both the short end of the curve (1-2 yr) and the longer end (8-13 yr) to maximize yield and take advantage of the steep municipal yield curve. We do not see an imminent threat from significantly higher inflation. Our overall duration target remains within the 4.50-5.50 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.
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 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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