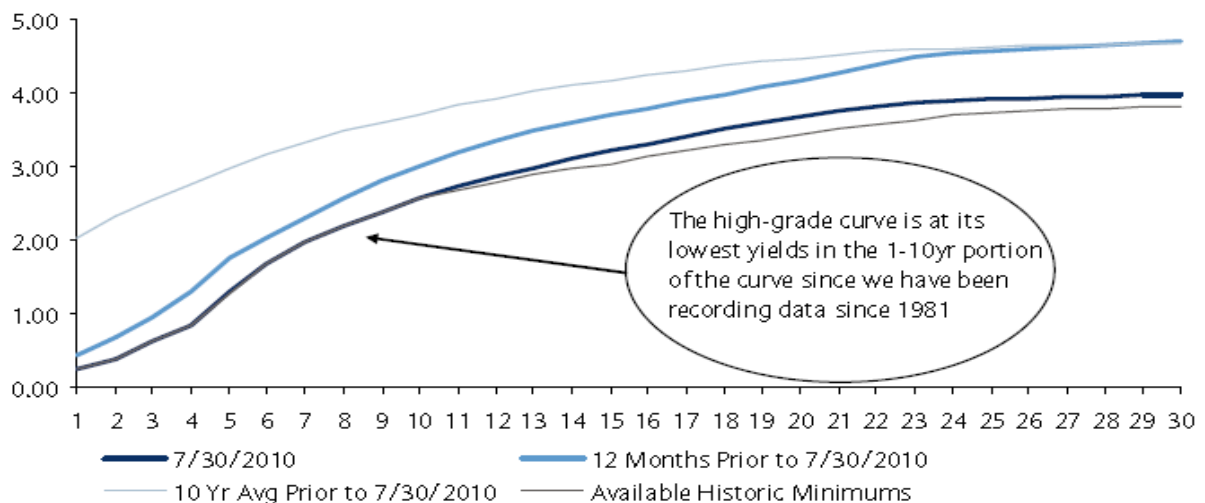


Economists expect moderate growth in the second half of 2010 and they believe that a double-dip recession is unlikely, with business expansion and growth in corporate profits set to contribute to employment growth and a stable GDP...

Overview

- Light supply, the search for additional yield and poor economic data supported the tax-exempt market during July after posting slightly negative returns in June.
- At current valuations, taxable spreads continue to appear wide when compared to both corporate and Treasury yields.
- The spreads of lower quality municipal bonds have tightened dramatically since late 2008, but continue to remain wider when compared to historical averages.
- The tax-exempt curve will likely maintain its steep shape through year-end as slow growth encourages the Federal Reserve Bank to leave rates unchanged for the year.
- As the graph below indicates, high quality tax-exempt yields remain at multi-generational lows and prompt investors to seek additional yield by investing in municipal bonds with longer maturities or lower credit quality.

Figure 15: High Grade Curve—July 30, 2010



Source: Barclays Capital

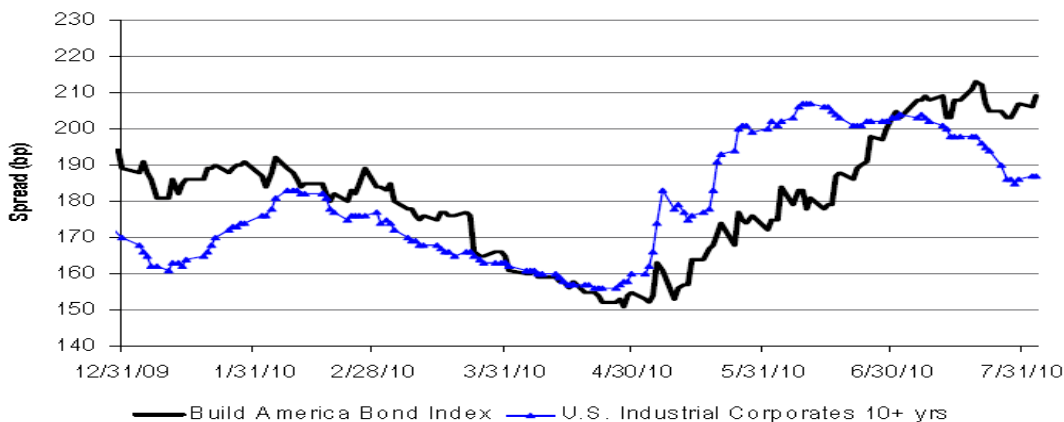
The Municipal Market

The municipal market recovered in July after posting slightly negative returns in June. Yields declined at month-end in response to the Treasury market rally. Nevertheless, we think the municipal market remains attractive versus Treasuries and investment grade corporate issues. The ratios of 10-year AA and A-rated munis to Treasuries are 1.1 and 1.3 respectively, far above the traditional averages of 0.8-0.9. The ratio of yields on 10-year A-rated municipal GOs to 10-year A-rated corporate industrial issues is also above 1.0. Over the past twenty years, that ratio has been in the 0.75 to 0.80 range. For instance, 10-year bonds that were recently issued by McDonald's (A-rated) were yielding approximately 50 bps below comparable maturity A-rated municipals.

Build America Bonds (BABs) Spreads Remain Wide Relative to Corporate Bonds

After widening significantly from a low of 151 bps over Treasuries in April, the ML BAB index spread to Treasuries is currently 209 bps. As the following chart shows, BABs and corporate issues underperformed the strong rally in Treasuries in May and June. Since then, as risk appetite returned to the markets, corporate spreads narrowed. In contrast, BAB spreads have remained wide and have been trading in a narrow range since mid-July.

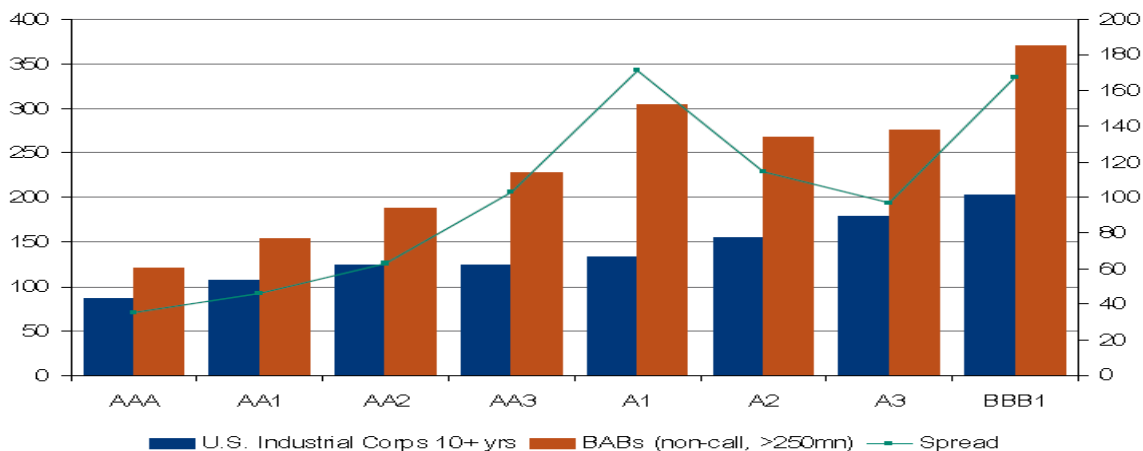
Chart 3: Build America Bond and U.S. Industrial Corporates 10+ yrs spread to Treasuries



Source: BofA Merrill Lynch Global Research

The following chart shows the average spread by rating for the Build America Bonds and U.S. Industrial Corporates (10+ years in maturity). BABs are trading at spreads of 40-180 bps to the corporate issues in each rating category. Spreads in the corporate market have compressed in recent weeks. In contrast, BAB spreads have remained wide due to credit quality concerns. Given the Fed's posture to keep interest rates steady in the foreseeable future, BAB spreads are likely to narrow as liquidity flows out the curve and investors reach for incremental yield.

Chart 5: Build America Bond and U.S. Industrial Corporates 10+ yrs spread to Treasuries



Source: BofA Merrill Lynch Global Research

Other Fixed Income Sectors Appear Overvalued Relative to Municipal Bonds

Along with the corporate bonds, Treasury, MBS (Mortgage Backed Securities) and TIPS appear to be overvalued. The Treasury market got most of the attention last month as it set record lows for 2-year yield. The 3 to 7-year segment had yields lower by 10 to 15 bps, while the 10-year was essentially unchanged. The 2-30 year spread increased by 15 bps. Apparently the flight to quality by foreign investors did not include the longest maturities. TIPS underperformed last month with a total return of only 0.14%. TIPS have underperformed by about 15 bps year-to-date and yields are extremely low, even for a low inflation environment. In fact, they appear to be priced for deflation instead.

Spreads on mortgages continued to narrow throughout July and they are now to only 50 bps versus the 10-year Treasury, the narrowest on record. The absence of new supply has forced portfolio managers to accept spreads that normally would be considered as far too meager and leave the mortgage market vulnerable to any back-up in Treasury yields.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) widened 8 bps in July, to 360 bps, its highest level since January, as yields dropped throughout the curve and the 1-10 year yields fell to historical lows. Yields were lower by as much as 34 bps in 4-year yields, with the 2-year down 13 bps and the 30-year down 5 bps. So far this year, the largest declines in yield along the curve have been in the 7-10 year spots, which have experienced declines of 40 bps or more. The Treasury curve widened as well; the 2-30 year Treasury spread increased 16 bps, to 344 bps as 2 year yields dropped 6 bps and the 30 year yield rose 10 bps.

APA's Strategy

We continue to favor the short/intermediate part of the municipal bond yield curve (8-13 years) where the slope of the curve remains steep. Yields on shorter maturity bonds are too low, while yields in the long end of the curve are depressed by the dominance of BABs in that maturity range.

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. Currently, investors can take advantage of the steep slope of the municipal curve to potentially make up the tax on out-of-state bonds by extending maturity just a year or two on the out-of-state paper.
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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Disclosure:

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