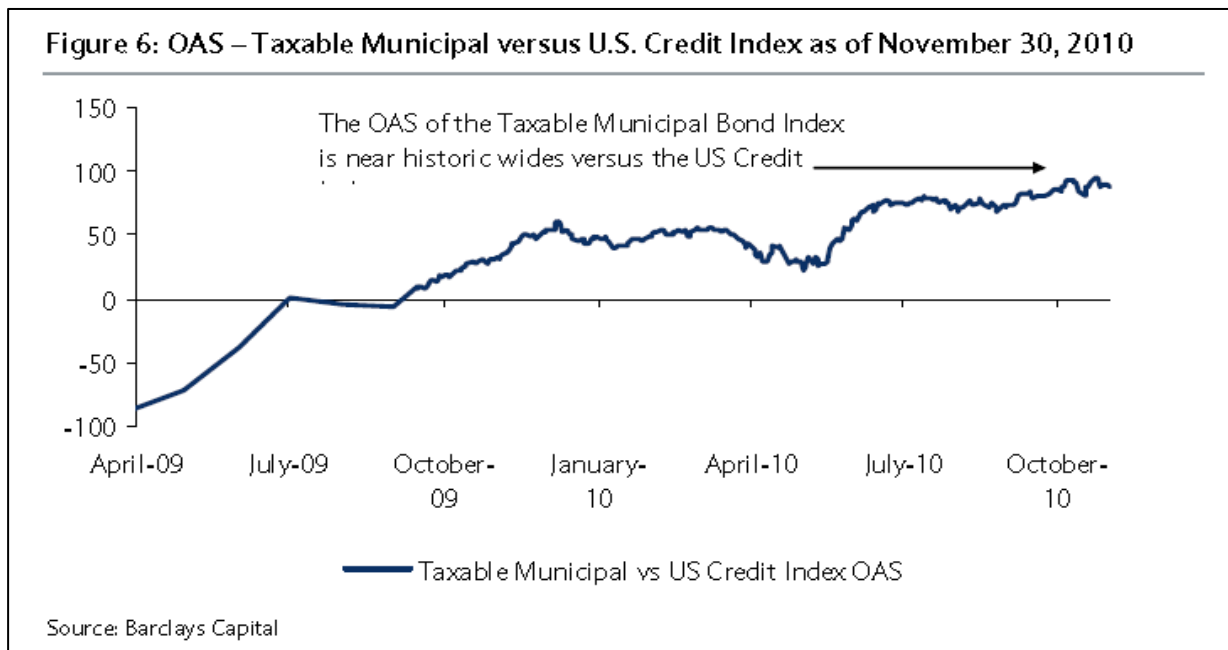


*The Federal Reserve Bank indicated that purchases of government debt, beyond the \$600 billion announced last month, could continue as unemployment may take five years to fall to a more usual level of 5-6%...*

### Overview

- An extension of the BAB program was not part of the legislation that the Senate passed on December 15. As a result, the Build America Bond Program will expire on December 31, 2010. \$175 billion BABs have been issued since the program's inception in April 2009. The uncertainty of the program's extension has weighed heavily on the municipal market in recent months.
- Municipal defaults are expected to remain low, despite the difficult budget environment, as states have demonstrated their will and ability to cut spending to offset structural imbalances. Public entities plan to spend and borrow less and have implemented policies to begin to address longer term pension and healthcare liabilities.
- The spread between Taxable Municipals and Corporate bonds has widened near record high historical levels as the following graph shows:

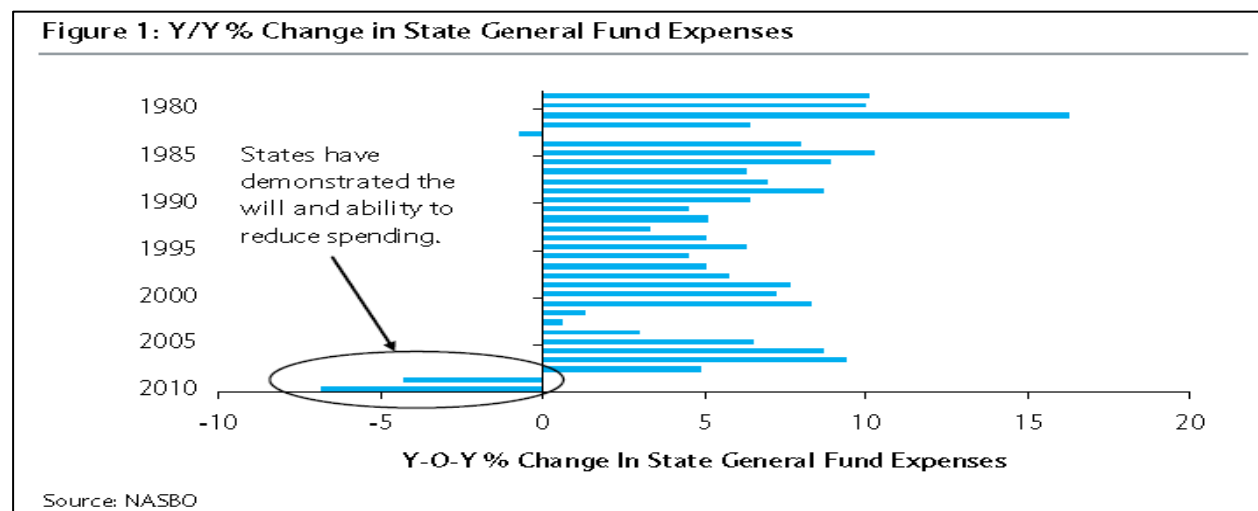


## The Municipal Market

Even though the BABs extension did not pass, we expect the municipal market to continue to operate in an orderly fashion, although the cost of capital will rise across the curve early next year. The most dramatic effects would likely be in the 15+ year part of the curve, with some of the pressure on longer-dated yields mitigated by manageable supply. In addition, the market is likely to be more susceptible to volatility and intermittent liquidity shocks. The distribution of securities will be more sensitive around periods of elevated issuance, severe mutual fund outflows and credit shocks.

## States Have Cut Spending and Began to Address Long-Term Liabilities

To offset declining tax receipts, many municipalities have been trimming expenses. In fact, according to the National Association of State Budget Officers (NASBO), 43 states cut their budgets in 2009 and 42 did the same in 2010. By contrast, just two reduced their budgets on an annual basis in 2006. As the following graph shows, general fund spending cuts in 2009 and 2010 were the first cuts since 1983 and the first consecutive year contractions since NASBO records began in 1979:



Pension obligations and retiree benefits will clearly be an issue for many states if steps are not taken to limit current employee retirement policies and additional capital is not saved to cover these obligations. Investors in municipal bonds may have the European debt crisis and negative financial media coverage to thank for some of the steps taken or proposed to relieve pension liabilities. Many states have taken steps to address long-term liabilities, including pension funds, by increasing employee contributions, extending vesting periods and adjusting payout formulas lower. For instance, California rolled back pension benefits for new employees to 1999 levels, increased employee contributions 3% and passed legislation strengthening its rainy day fund policy. Illinois raised its retirement age for new employees from 60 to 67

and ended the practice of allowing retirees to receive a public pension at the same time as earning a second salary from a public entity. In addition, cost reductions have taken the form of delayed or cancelled projects, reduced services and the trimming of the public sector workforce. One of the largest projects cancelled was a plan to build a rail tunnel between New Jersey and New York City.

## BAB Spreads Have Begun to Tighten

Spreads of Taxable Municipal bonds have begun to tighten, and the spread tightening between the Taxable Municipal index and the Corporate index is expected to accelerate. The spread of the Taxable Municipal index tightened 21 bps, to 218 bps, since the end of November. We expect longer term spreads to continue to tighten steadily as supply dwindles and bonds continue to be sought after by pension funds and life insurers. As the following table shows, spreads in the highest quality (Aaa) sector of the markets are surprisingly large, with the spread of Aaa-rated taxable municipals 106 bps wider than Aaa-rated corporate issues.

**Figure 7: OAS by Rating (bp), November 30, 2010**

	U.S. Taxable Munis	U.S. Credit	Difference
Aaa	145	39	106
Aa	214	120	93
A	308	166	142
Baa	293	204	88
Total	247	159	88

Source: Barclays Capital

## The Municipal Yield Curve

The spread between the municipal high grade 2-year and 30-year spots increased by 28 bps in November, to 368 bps, the widest level since August 2009. Fifteen year plus yields experienced the highest rise, by 40-47 bps during the month. Since the end of 2009, 2-30-year tax-exempt spreads have increased by 11 bps. The 10-30-year spread ended the month 14 bps higher, at 149 bps, just off its highest level this year of 161 bps on November 17. To date this year, according to the high grade scale, the largest decline in yield along the curve has been in the 6-year spot, which experienced a drop of 42 bps, while the 21-year and 22-year spots rose 25 bps. The Treasury curve steepened; the 2-30-year Treasury spread rose to 367 bps, as 2-year yields were up 13 bps and the 30-year yield increased 14 bps. The 5-year bellwether rate was 30 bps higher, while the 10-year climbed 21 bps. For 2011, market participants expect various factors such as fluctuating dollar, inflation and economic news, to keep Treasury rates volatile and cause municipal yields to rise modestly by the end of next year.

## APA's Strategy

We continue to favor the short/intermediate part of the municipal bond yield curve (5-13 years) where the slope of the curve remains very 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, given the lower yield environment and the steep municipal yield curve, our strategy regarding yield curve positioning remains as follows:
  - 10% of total holdings allocated to 0-2 years in maturity.
  - 70% of total holdings allocated to 5-13 years in maturity.
  - 20% of total holdings allocated to municipal bonds that present an investment opportunity including longer duration callable issues, specific credits that appear to be undervalued etc.

In addition, we do not see an imminent threat from significantly higher inflation. Our overall duration target remains within the 4.00-5.00 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 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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