



MARKET COMMENTARY

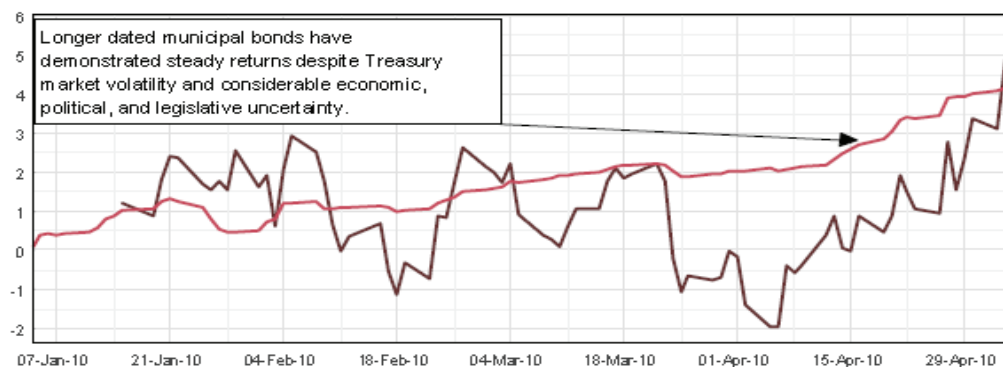
May 2010

The economy continues to improve despite the debt crisis in Europe as we have found the last two employment reports have been encouraging and consistent with buoyed consumer spending and sentiment. Public and business sector spending have been the primary components of growth in the current cycle as consumer spending increased 3.6% during 1Q 2010 while business investment rose 13% during the same period...

Overview

- In our view, the tax-exempt municipal market has held up relatively well, despite the widespread uncertainty and volatility experienced in the broader fixed-income markets.
- Strong demand coupled with limited tax-exempt supply due to the existence of BABs helped to insulate the tax-exempt market and keep yields relatively steady despite the difficult economic environment.
- Taxable municipals experienced spread widening in line with broader credit markets as risk-averse investors reacted to concerns over the European debt crisis.
- As the graph below indicates, tax-exempt municipals lagged Treasuries in total return due to the recent flight to quality trend. Going forward, reduced municipal supply should provide a favorable environment for steady tax-exempt returns, despite the volatility in longer-dated Treasury yields and an abundance of economic, political and legislative uncertainty.

Figure 4: Year-to-Date Total Return of the Long Municipal Index and 25y+ Treasury Index



Key Axis Name
 Left US Treasury: 25+ Yr - YTD Total
 Left Municipal Long (22+) - YTD Total

Source: Barclays Capital



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The Municipal Market

As the following table shows, AAA-rated municipal yields held steady through roughly the 10-year maturity range, with yields dropping 5 to 7 basis points on the long end. Compared to Treasuries, tax-exempt bonds underperformed considerably with 10-year Treasury yields declining 35 basis points and 30-year Treasury yields declining 41 basis points for the same period.

AAA GENERAL OBLIGATION YIELDS

Date	1-yr	3-yr	5-yr	7-yr	10-yr	12-yr	15-yr	20-yr	30-yr
04/29/2010	0.39	1.03	1.72	2.42	2.94	3.15	3.40	3.79	4.06
05/06/2010	0.39	1.03	1.72	2.42	2.93	3.10	3.34	3.72	3.99
Change in bps	0	0	0	0	1	5	6	7	7

Source: Thomson Reuters MMD

Consequently, AAA-rated municipal yields as a percentage of Treasury yields increased significantly over the last week: 10-year AAA-rated bonds reached 83.1% of Treasury yields and 30-year municipal yields were up to 91.6% of 30-year Treasury yields. In the past, when Treasury yields dropped rapidly as a result of a flight to quality, neither municipal bonds nor taxable sectors, measured as a spread to Treasuries were able to keep pace. In addition, tax-exempt issues are unlikely to match the lower yields experienced in Treasuries, since 10-year AAA-rated tax-exempt bonds are already yielding below 3%.

Municipal Volume Patterns

In our opinion, some interesting municipal volume patterns have developed since the beginning of the year:

- Year-to-date total municipal volume is higher, but tax-exempt volume is down as BABs issues account for 30% of total supply. Total issuance was up 6.10% year-to-date versus 2009 level; however, 32.40% of that issuance has been taxable issues. Taxable issuance increased 209% from \$13.5 billion to \$42.1 billion, including \$33 billion of BAB issuance. Tax-exempt issuance actually dropped by an impressive 19.9%, from \$108 billion to \$86.5 billion.
- Revenue bond issuance represented a significantly larger share of total issuance during 2010, increasing by 17.7% as GO issuance dropped 7.4%. This pattern reflects the ongoing pressures



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on state and local budgets, including some of these governments to secure financings with dedicated revenue streams.

- Bond insurance coverage continues to decline. Insured municipal paper comprised 47% to 49% of total volume during 2007-2008. So far in 2010, only \$8.0 billion has been insured paper or 6.1% of total supply, posting a 48% year-over-year decline.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) tightened 2bps during April, as 2-year and longer yields fell across the curve. Yields were lower by 10 bps in the 2-year maturity range, 12 bps in the 30-year and as much as 15 bps in the 10-year portion of the high grade curve. The Treasury curve also flattened in April. The 2-30 year Treasury spread tightened 14 bps to 355 bps as 2-year yields fell 6 bps and 30-year yields dropped 20 bps. Treasury yields have been volatile recently in response to positive corporate earnings news and Federal Reserve Bank's policy on short-term rates, but negative feedback on SEC investigations and the debt crisis in Europe has resulted in a flight to quality. A stable global and economic outlook with sustained growth would be reflected in rising Treasury yields and a flattening curve. The municipal curve is likely to flatten from its current steep level and gradually revert closer to its 10-year historical average of 221 bps.

Fitch Finalizes Recalibration; Moody's Near Completion

As of April 30, 2010, Fitch ratings completed the recalibration of U.S. public finance credit ratings. Under its process, the rating agency re-rated over 38,000 bonds. It adjusted general obligation and revenue bonds that were previously rated A to BBB-, upward two notches. Fitch also increased GO ratings, that were previously rated A+ or higher, one notch upward. Water and sewer and public power distribution credits were readjusted in the same way as GO ratings. Public higher education bonds, previously rated AA- to BBB-, were moved up one rating criteria as well. There was no adjustment made on public higher education ratings of AA and higher or any private higher education ratings.

Moody's started its recalibration process on April 16, 2010 and is expected to adjust 70,000 bonds from 18,000 issuers by May 10. The rating agency has already completed the process for states, with California and Puerto Rico adjusted upward by three notches each (they are now rated A1 and A3, respectively). Under Moody's recalibration, Indiana, Tennessee, Texas, New Mexico and Iowa all have been newly rated as Aaa.



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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 and issuers that are substantially insulated from budgetary pressures hitting many state and local governments. Pressures on state and local governments are typically related to employee compensation costs; revenue bond issuers may be in a stronger position to control employee costs without political interference than many state and local governments.

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 an 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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APA-10-62