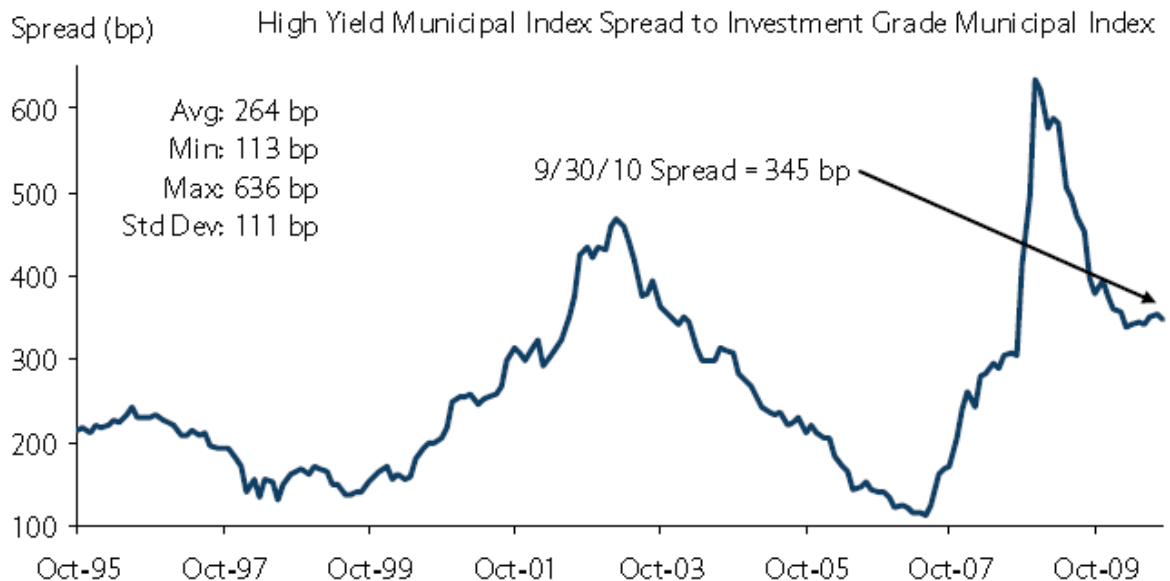


Several market participants expect the Federal Reserve Bank to keep interest rates steady throughout 2011, especially after its recent statements that support future asset purchases. The final reading of second quarter U.S. GDP was 1.7%, confirming relatively sluggish expansion after 3.7% and 5.0% growth in 1Q 2010 and 4Q 2009, respectively...

Overview

- Yields on the tax-exempt municipal curve moved higher during September, due to negative headlines, higher supply and slower mutual fund flows.
- We think taxable municipal issues continue to offer value as they trade at historically wide spreads versus the U.S. Credit Indices. The spread between the Taxable Municipal Index and the U.S. Credit Index is 81 bps, at its widest ever.
- With its fifth best quarterly performance since inception, 3Q 2010 and Y-T-D returns for the High Yield Index outpaced the Municipal Index by 114 bps and 533 bps, respectively. Despite the rise in investment grade municipal yields this month, investors will likely continue to tap into high-yield sector for total return opportunities.



The Municipal Market

The gradual decline of tax-exempt municipal yields came to a halt as new issue volume increased, the media found renewed focus on municipal credit conditions and low absolute yields slowed down demand for municipal bonds. The market appeared to be overdue for a correction after yields declined steadily from April through August. Several market participants expect the municipal market to be sensitive to future supply as tax-exempt issuance is projected to remain high relative to the first three quarters of the year due to the extremely low cost of capital and the elevated need for local government funding. The increased market focus on credit issues could lead to higher yields in the short-term as continual press coverage on fiscal matters require time and effective policy to overcome.

Renewed Media Focus on U.S. State Creditworthiness

A recent report that was widely distributed and extensive media coverage that followed, has focused on the fact that municipal budgets have become strained following the economic downturn. In addition, states have tended to focus on immediate liabilities and delay nonessential payments for future periods. Following every economic downturn, municipal revenue growth has decelerated when economic activity has waned and asset values have fallen. Given that the economy has recently exited the worst recession in more than 70 years, it is expected that reductions in revenues would be severe and balancing state budgets exceedingly challenging. This is also evident at a national level, as the federal government reported a \$1.3 trillion deficit for fiscal 2010, the second largest since 1945. The severity of the recent recession and growth in underfunded longer-term obligations have left municipalities open to criticism over a general lack of managing expenses lower as revenues have declined considerably. Despite the difficult budgetary environment, market participants do not expect a default on state general obligation issues. In large part, at a state level, the debt burden is not the lion's share of the fiscal burden. In fact, median debt as a percentage of gross state product is just 2.22% according to Moody's. Furthermore, debt service is typically a high priority obligation. For instance, according to its annual report for fiscal 2009, California is facing about \$2.9 billion in debt maturities this year and a similar amount next year, less than 0.4% of the state's GDP. Illinois will have to repay about \$1.5 billion in principal this year and next, or 0.3% of its GDP. The totality of state and local governments' interest paid and debts retired or refinanced in 2008 was 2.4% of U.S.GDP. Aside from its diminutive size, what is noteworthy about this figure is how stable it is over time. In 2007, state and local governments' interest paid plus debts retired or refinanced in 2008 represented 2.3% of U.S. GDP. The figure has stayed between 1.97% and 2.66% since 1995. As a comparison, the federal government's payment of interest and principal will require 6.9% of current GDP, followed by a spike to 8.5% in 2012.

In many states, funding levels for pensions and other retiree benefits have suffered as asset values have declined and revenues have fallen. States have the ability to reverse the tide of rising structural deficits through their power to raise taxes, cut services and renegotiate labor or lease agreements. Historically, tax revenues have picked up on a 12-18 month delay following cyclical expansions. The extended period of accommodative policy and the expected asset purchase program should promote additional hiring and a more robust economic expansion. Many analysts also expect the current high level of attention being paid to longer-term obligations to provide the political mandate to allocate future revenue gains to fund longer-term liabilities. In addition, local municipal bond issuers are expected to act more prudently in managing their longer-term liabilities than they have in the past. There are examples of states instituting more realistic pension and benefit agreements than in the past. Governor Schwarzenegger is in the process of renegotiated existing labor contracts in California and has reached agreements with seven labor unions so far, the latest being the SEUI (Service Employees International Union Local 1000), which recently agreed to a 3% increase in employee contributions to its retirement plan and a rollback of pension formulas for new hires to pre-1999 levels. Furthermore, as part of the budget proposal that was just approved by the Assembly, “rainy day” funds will be strengthened by increasing the size to 10% from 5%, requiring annual contributions and restricting their use to only when needed.

Municipal Bonds Face Less Rollover Risk

A common risk in most financing markets is “rollover risk”. When a borrower has a debt maturity coming due, it often needs to borrow again to pay off the existing loan or “roll it over”. This presumes access to functioning capital markets where investors are willing to extend loans. However, this is not always the case: borrowers unexpectedly facing the prospect of failing to roll over debt were a primary cause of the financial crisis in 2008. Since municipal borrowers in the U.S. generally plan to pay off debt steadily over time from taxes and other revenues, rather than roll it over, this risk is far slighter in municipal investing than in most other markets. Municipalities that sell bonds to raise money for a project usually size the maturities of the bonds to achieve level debt service. This means the interest and principal payments will be roughly even each year until the final bond matures. Also, municipalities usually have a predictable cost of repaying debt each year. They do not need to borrow money again to pay off the debts they already have.

The Municipal Yield Curve

The municipal high grade spread (2-30 year) tightened 9 bps in September, to 323 bps, its lowest level since September 2009, as short-intermediate yields rose more than the long end of the curve. Yields were up just 3 bps in 30-year, but the 2-year was higher by 12 bps. The 10-30 year high grade

spread tightened 17 bps to end the month at 132 bps, while the 5-10 year spread widened 9 bps, to 121 bps. So far this year, according to the high grade scale, the largest decline in yield along the curve has been in the 9-year spot, which experienced a drop of 64 bps. The Treasury curve steepened; the 2-30 year Treasury spread rose 22 bps, to 326 bps as 2 year yields dropped 5 bps and the 30 year yield rose 17 bps.

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 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, we have adjusted our strategy regarding yield curve positioning 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 4.50-5.00 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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