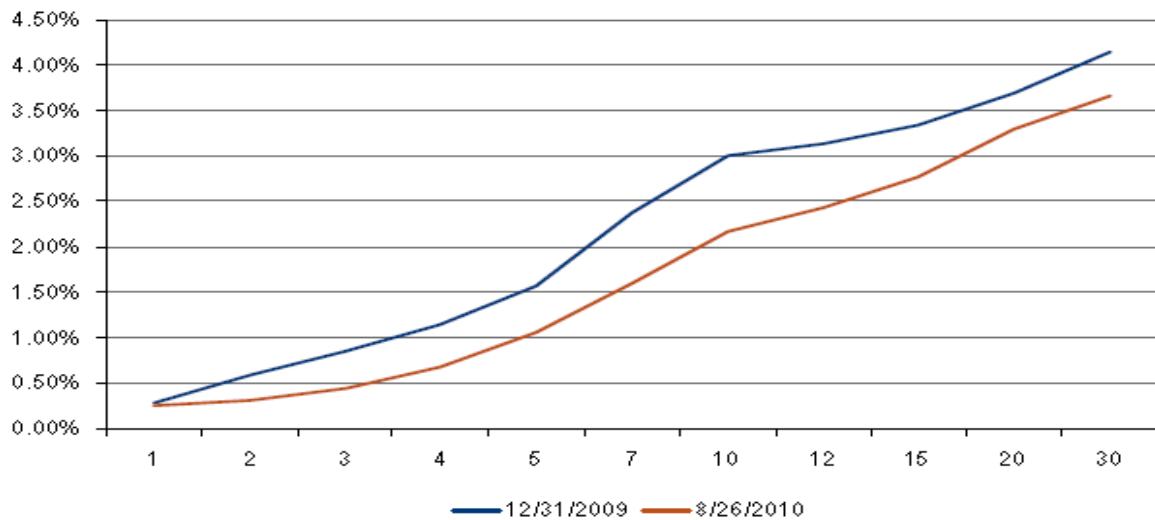


Economists expect growth to slow to 2.5% next year from a projected 2.7% this year as unemployment above 9% tempers the housing market and consumer spending...

Overview

- Yields throughout the tax-exempt municipal curve are at historical lows, due to the low Treasury yield levels, strong municipal capital flows and low tax-exempt issuance.
- Record low yields for high grade assets have motivated some investors to move outside of their traditional investment mandates. Within the highest rating categories, the top yielding municipal bonds are often in the housing and healthcare sectors.
- The extension of the authorization for Build America Bonds (BABs) issuance beyond 2010 is still questionable. The probability of passage drops further if the bill is not passed prior to the November elections.
- As the graph below indicates, the municipal curve has flattened since the beginning of the year as rates on the long end have moved lower.

Chart 1: AAA muni yield curve



Source: Thomson Reuters MMD

The Municipal Market

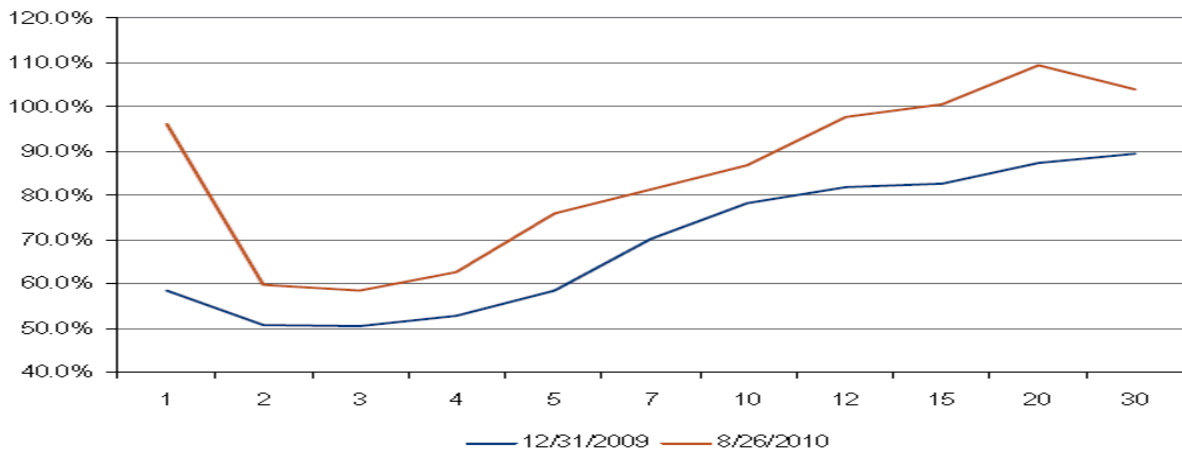
Absolute yields on tax-exempt bonds continue at or near record lows, especially these yields in the 10-year and shorter maturity range. The rally in municipal bonds can be attributed to several factors:

- Consistently weak economic data which leads to investor flight to higher quality assets such as municipal bonds.
- Build America Bonds (BABs) issuance continues to erode tax-exempt supply.
- Rising federal tax rates for upper income taxpayers, the core buyer of tax-exempt bonds, still loom in 2011.
- Strong flows to municipal bond mutual funds and continuing robust retail demand in spite of all-time low rates.

The general themes in the market also support the rally. Slow GDP growth and disinflation have been positives for the credit markets. In addition, easy monetary policy and low short-term rates have channeled liquidity into riskier assets with both longer duration and lower credit characteristics. Slowing growth and tight credit conditions affecting the household and small business sectors have recently contributed to concerns over a prospective double dip recession and the possibility of deflation, given the lack of corporate pricing power.

Given the strong rally in Treasuries, Municipal/Treasury ratios have moved higher across the curve as the following chart shows. The 10-year Muni/Treasury ratio is now at around 87%, having started the year at 78%.

Chart 3: Muni / Treasury ratio curve

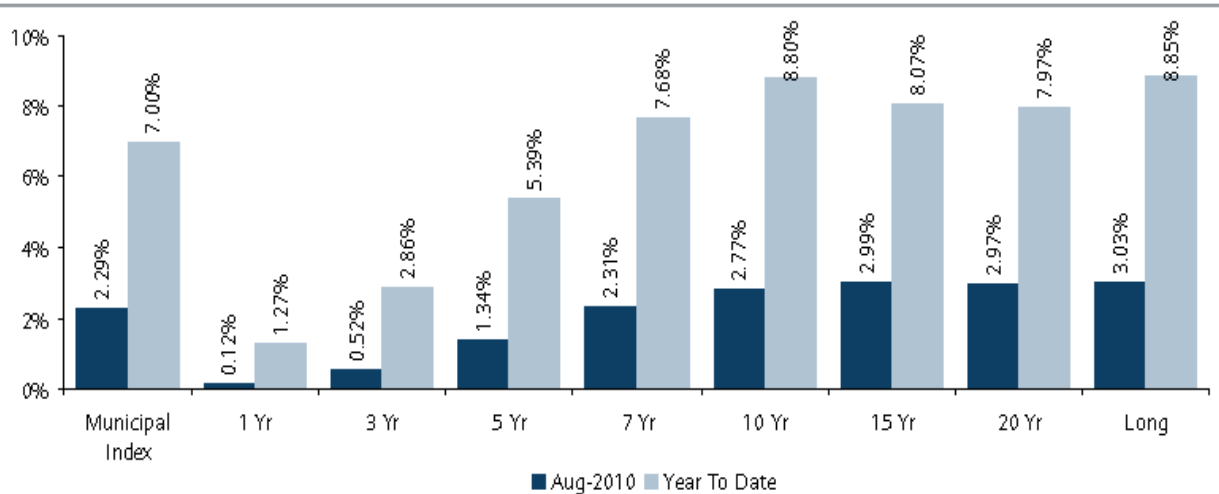


Source: BofA Merrill Lynch Global Research

Municipal Market Performance

The tax-exempt market has registered some impressive price gains throughout the investment grade sector. The higher yielding sectors had the best returns in the Municipal Index, as the longer part of the curve and lower rated bonds were the largest outperformers. As the following graph shows, the lion's share of performance throughout the curve and across ratings categories occurred in the 7 to 15 year maturity range.

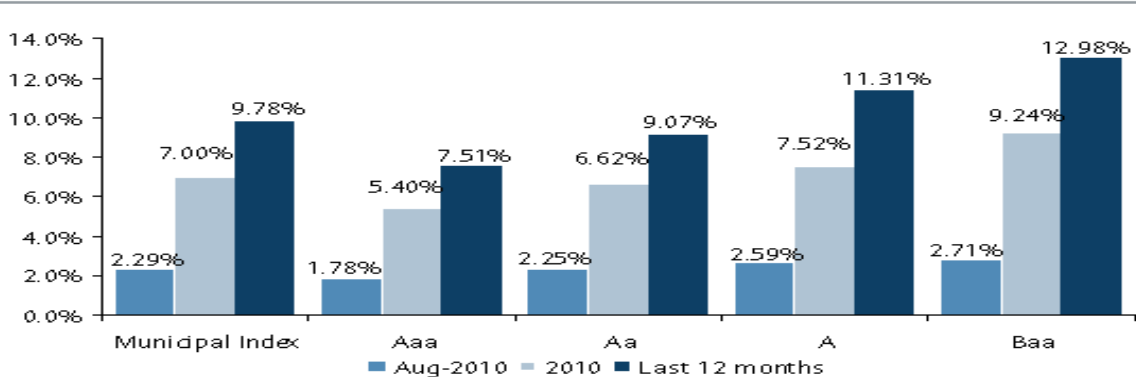
Figure 70: Municipal Index Returns by Maturity



Source: Barclays Capital

Across ratings categories Baa-rated credits were the strongest performers in August. As the following graph shows, the Aaa-rated sector (1.78%) and Aa-rated sector (2.25%) underperformed, while A (2.59%) and Baa (2.71%) bonds surged higher. The High Yield Municipal Index (2.48%) outperformed the Municipal Index for the ninth straight month.

Figure 71: Municipal Index Returns by Rating



Source: Barclays Capital

The Municipal Yield Curve

The municipal high grade spread (2-30 year) tightened 28 bps in August, to 332 bps, its lowest level since October 2009, as yields dropped to historical lows throughout the curve. Yields were as much as 45 bps lower in 15-year, with the 2-year down 2 bps and the 30-year down 30 bps. The 10-30 year high grade spread widened 9 bps to end the month at 149 bps, its highest since late November 2009. So far this year, the largest declines in yield along the curve have been in the 8-10 year spots, which have experienced declines exceeding 80 bps. The Treasury curve also flattened; the 2-30 year Treasury spread fell 40 bps, to 304 bps as 2 year yields dropped 8 bps and the 30 year yield fell 47 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.

Costas Kalaitzidis, CFA

Analyst / Portfolio Manager

costas@assetpreservationadvisors.com

Disclosure:

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