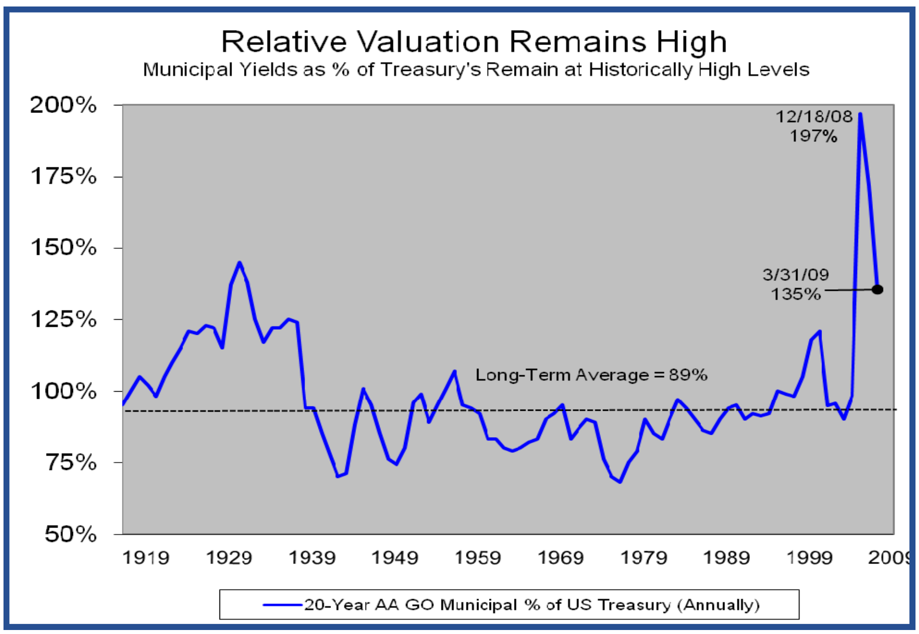
First Quarter 2009 Report

Overview of Municipal Markets

After suffering their worst calendar-year decline on record in 2008, municipals began 2009 by embarking on a notable turnaround. During the first quarter of 2009, the municipal yield curve experienced a bullish steepening with yields declining all across the yield curve. Referring to **Figure 4** on page four, we can see that while yield levels declined for all maturities, yields on short and intermediate maturities declined more than long-term yields, with yields on 2-year maturities declining by 75 basis points and yields on 30-year maturities declining by approximately 18 basis points. As a result of this bullish reshaping, the municipal yield curve is currently the **steepest it has been since the early 1980's**. Referring again to **Figure 4**, we can see that the March 31, 2009 municipal yield curve, with a 2s-to-30s yield spread of **411 basis points**, is roughly twice as steep as the **trailing ten-year average yield curve**, with a 2s-to-30s yield spread of **207 basis points**. The cross-over yield between the current municipal yield curve and the trailing ten-year average yield curve occurs around the 15-year maturity area. As such, the record steep slope of the current municipal yield curve favors investment of new money in the 10 to 15-year area of the curve.

Referring to **Figure 5**, we can see that during the first quarter of 2009, municipal yields as a percentage of Treasury yields declined somewhat from their record levels of the fourth quarter as municipal yields declined and Treasury yields rose, with the bulk of the decline occurring at the front end of the yield curve where the rally in municipal yields was the most pronounced. However, when compared to the trailing 10-year average, municipals still offer compelling value for taxable investors across the curve, with 5-year municipals trading at yields equal to 146 percent of Treasury's versus the trailing 10-year average of 80 percent, and 30-year municipals trading at yields equal to 149 percent of Treasury's versus the trailing 10-year average of 91 percent. That **high quality municipal bonds** continue to offer historically unprecedented value relative to Treasury's, is further illustrated by **Figure 1** which graphs the ratio of 20-year municipal yields to 20-year Treasury yields over the past century. And despite the correction of the first

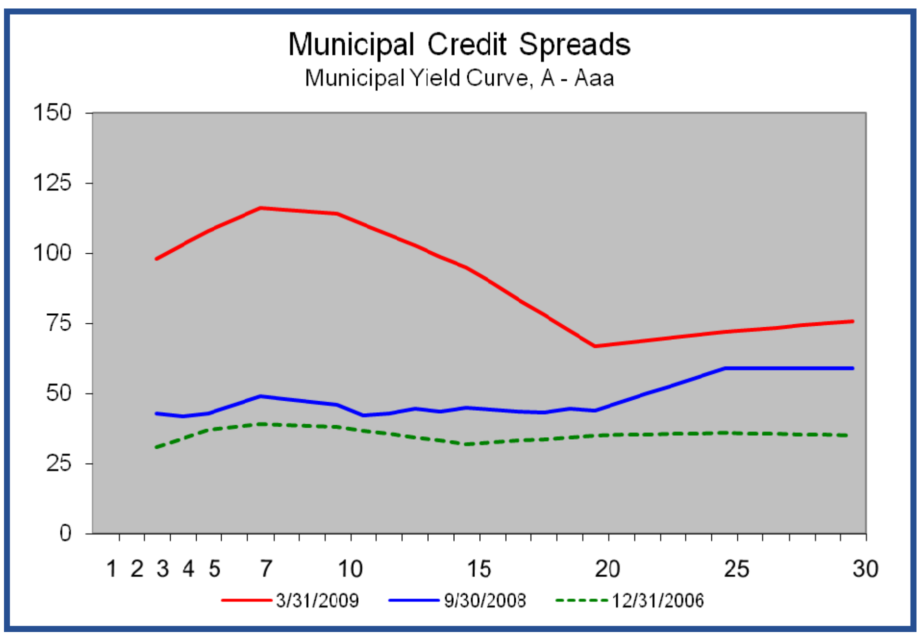
Figure 1



quarter, municipal yields are still trading at levels nearly **50 percent** above their long-term average. As we have discussed previously, the increase in municipal yields as a percentage of Treasury yields to record levels was driven by a combination of **severe dislocation** in the municipal market and a **massive flight to quality** in favor of Treasury's during 2008. The primary factors behind the dislocation of the municipal market included the loss of the **monoline insurers**, the collapse of the **auction rate securities market**, and the loss of several large **institutional liquidity providers** including broker/dealers (Bear, Lehman, Merrill) and leveraged hedge funds. The loss of these institutional investors, a significant source of demand in the municipal markets, along with a marked increase in risk aversion and the resulting illiquidity, created unprecedented volatility and a general **loss of confidence** in municipals.

As a result of the loss of these large institutional buyers, the **demand structure** for municipals has shifted, with the **household sector** in all its forms – direct retail, mutual funds, bank trust departments and separately manage accounts – becoming the primary source of marginal demand for municipal bonds. It is the combination of this change in the structure of demand along with **heavy fixed-rate issuance**, which has had the greatest impact on both the slope of the municipal yield curve (steep) and municipal credit spreads (wide). (See **Figure 2**) Current demand from the household sector tends to be **risk averse** in terms of both maturity and credit rating, i.e., they tend to focus on short-to-intermediate maturities and Aa ratings or better. And perhaps nowhere else is the impact of the marginal increase in household demand more evident than in the fact that municipal yields declined markedly during a period when Treasury yields rose, while at the same time, total municipal issuance for the first quarter actually increased by approximately 2 percent over the first quarter of 2008. In an important sense, however, even this market action fails to convey the strength of the turnaround during the quarter because although supply only increased a modest 2 percent, variable rate issuance was down 65 percent, with **fixed rate debt** accounting for **90 percent** of all new issuance during the quarter, a 22% increase over last year. The strong support from the household sector is further revealed by the 55 percent increase in **net new cash flows** into municipal bond funds.

Figure 2



We continue to believe that the ongoing dislocation in the municipal market provides a unique **value proposition** for taxable investors. This value proposition is anchored by the fact that despite the recent correction in the ratio of municipal yields to Treasury yields, municipals remain at historically **high relative valuations** compared to high quality alternatives such as Treasury's, making this a very **attractive**

entry point. In addition, the recently approved **stimulus package** will directly benefit municipalities, offering significant assistance to issuers of municipal debt. With more than $200 billion aimed specifically at states and municipalities, municipal issuance is expected to moderate as more needs are met by federal aid. The federal focus on the plight of state and local governments will help to **restore confidence** in municipals as a high quality asset class. And finally, we believe that **potential tax law changes** will benefit the municipal market, with more and more investors eventually attracted to municipal bonds due to their favorable tax treatment. With tax burdens on the wealthy already headed higher with the likely expiration of the **Bush tax cuts** in 2010, and the prospects of a **federal tax rate increase** under the Obama administration as well as the potential for **states to raise income tax rates** in an effort to deal with budget shortfalls, we believe that municipal bonds will provide unprecedented value for investors who can benefit from the tax exemption of municipal income. This last point is aptly illustrated by **Figure 3**, which graphs the impact of both the current maximum federal tax rate of 35 percent as well as the proposed maximum rate of 39.6 percent on **after-tax municipal yields**. As we can see, given the record steepness of the municipal curve, tax-equivalent yields become quite attractive with even a **modest extension in maturity**, with the most compelling combination of risk and reward in the 10-to-15 year maturity area. With relative yields on municipal bonds at historically cheap levels, and with addition of direct federal aid to issuers, and with the potential for increasing taxes, and given their long history as a high-quality, low-volatility asset class, we reiterate our belief that now is an excellent time to **buy and hold** high-quality municipal bonds.

Figure 3

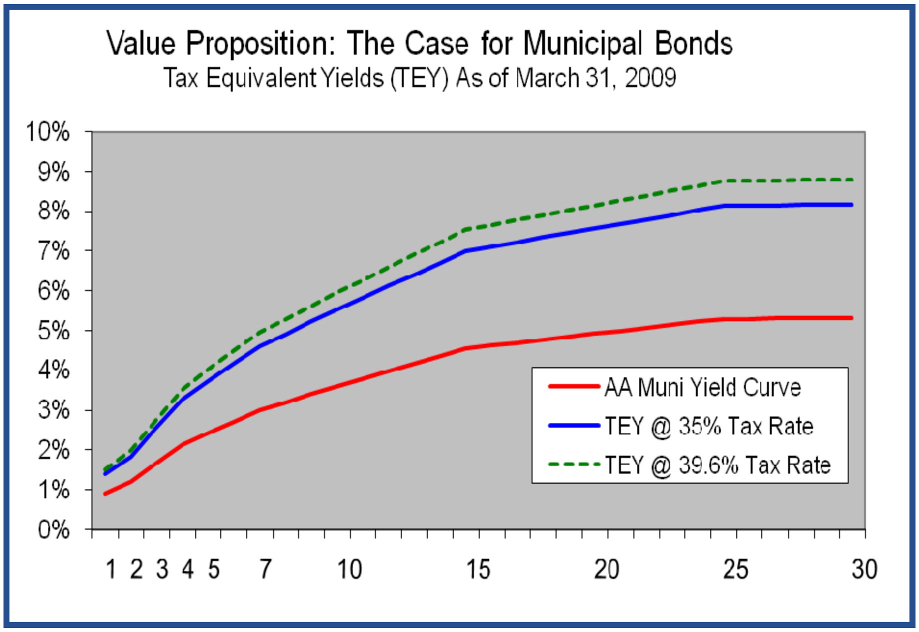


Figure 4

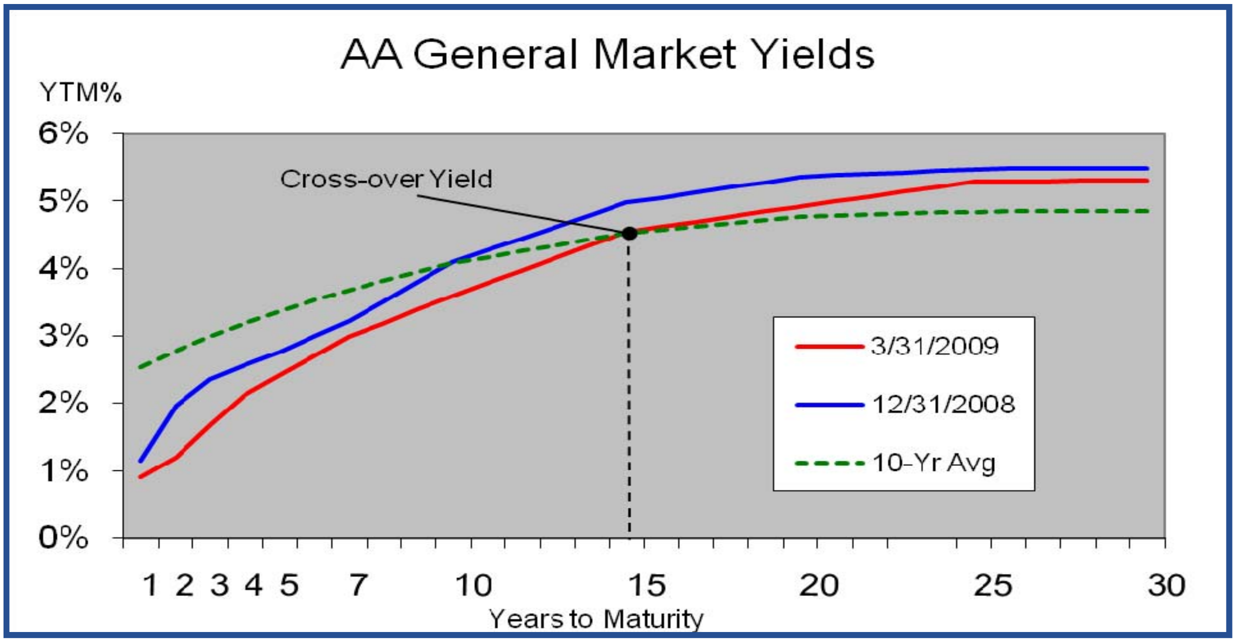
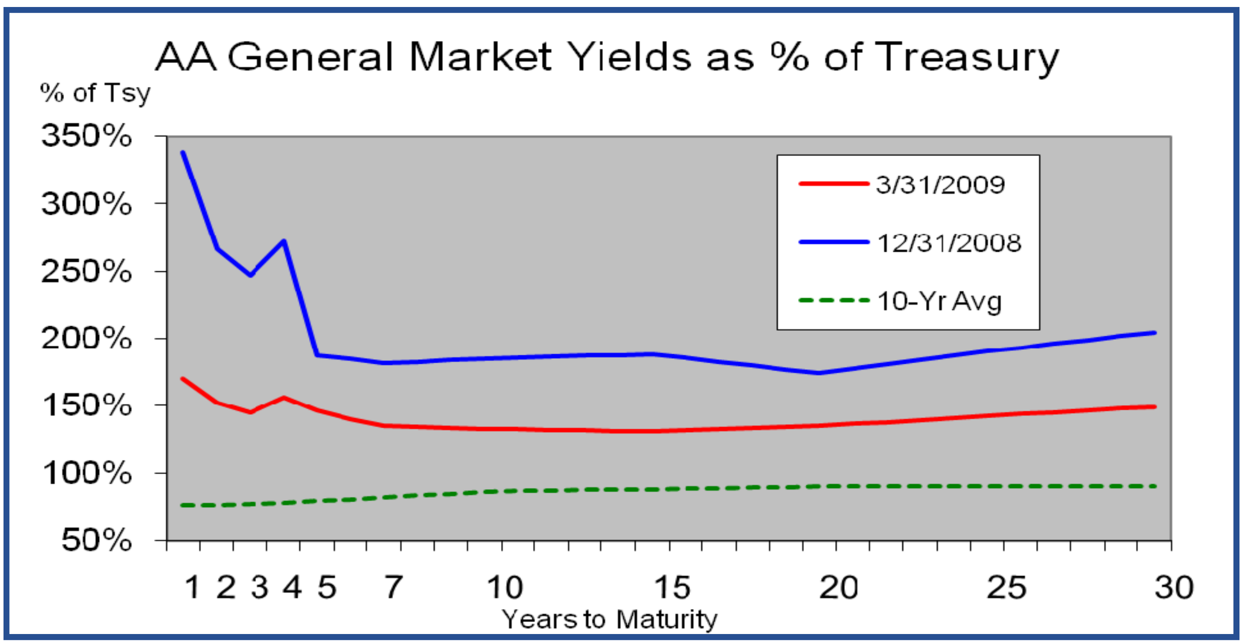


Figure 5



	10 Yr Avg	12/31/2008	3/31/2009
2-Year AA Municipal	77%	267%	152%
5-Year AA Municipal	80%	188%	146%
10-Year AA Municipal	87%	186%	133%
20-Year AA Municipal	90%	175%	135%