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CAPITAL
ADVISORS

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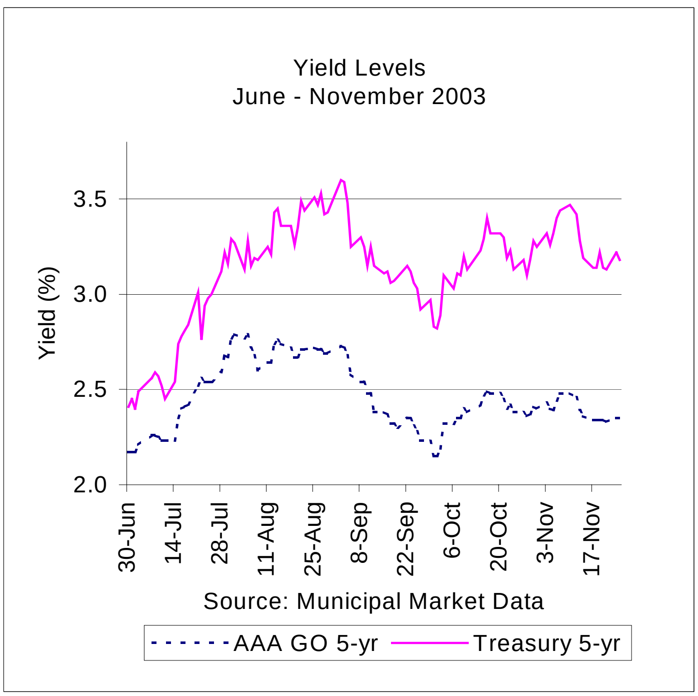
Over the last two quarters, we have seen a full interest rate cycle for municipal bonds. For much of the second quarter, yields of five-year municipal bonds rose reaching a high of 2.79%, up 62 basis points from the end of June. Over the same period, Treasury five-year yields rose to 3.60%, up 119 basis points. From the end of August, municipal prices regained most of the losses, recently closing at 2.35%, only 18 basis points higher than the end of the second quarter. Treasuries, meantime, have recovered to 3.18%, still 77 basis points higher than at the end of June. The better relative performance of municipal bonds was expected after supply moderated and retail demand picked up primarily for short maturity bonds.

The high volatility of yields over a relatively short period of time showed the prudence of a long-term outlook when investing for stability and income. Municipal bonds were much less volatile than Treasuries and recovered more of the early losses by the end of the third quarter. This trend should continue as municipalities benefit from a recovering economy with higher revenue and lower borrowing needs.



Evidence of economic recovery is abundant. Nearly every indicator shows an increase in activity. GDP in the third quarter is up 8.2%, Durable goods orders have risen in October by 3.3% following a revised September growth of 2.1%. As the economy recovers, the Federal Reserve is less likely to lower short-term rates.

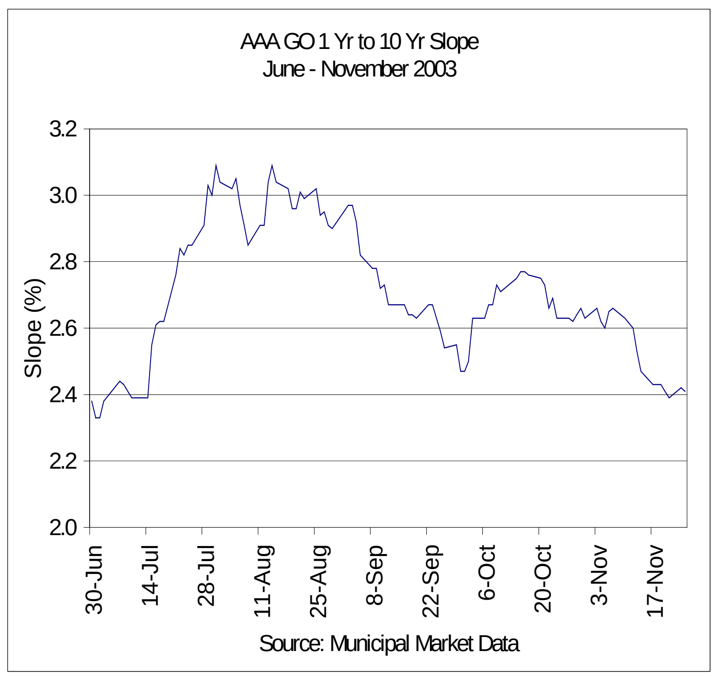
"Barbells" and "Bullets"

Typically, investors will compare the performance of investments to an index. For the municipal bond investor the indexes available are generally for a targeted maturity range. The index is chosen to match the risk tolerance and income needs of the investor. At times the mismatch between a portfolio that averages maturity and an index that targets maturity will have very different results. The return differences are generally caused by a change in the slope of the yield curve.

A maturity-targeted index is made up of a small portion of the municipal yield curve. Typically, a five-year index will contain bonds that mature between four and six years. This is known as a "Bullet" maturity structure.

Another strategy for investing for an average maturity of five years is buying very short bonds and very long bonds. This is known as a "Barbell". The portfolio has very little invested in the bonds that have the targeted maturity.

During the third quarter, the "Bullet" strategy had higher returns because the long bonds in the "Barbell" tended to drop in price more than the short bonds rose in price and the average of the two returns was lower than the "Bullet" bond return. However, the effect reversed when the yield curve recovered by the end of November.



A well-diversified portfolio will have a balanced approach to security selection. This means that the portfolio will maintain an average risk profile but hold a wide variety of securities to reduce the risk of any individual investment or sector of the market. We manage portfolios to reduce long-term risk while maintaining high tax-exempt income. In order to maximize both safety and return, we diversify the holdings over a wide maturity range. This allows parts of the portfolio to benefit from yield curve slope changes.