

Quarterly Market Summary

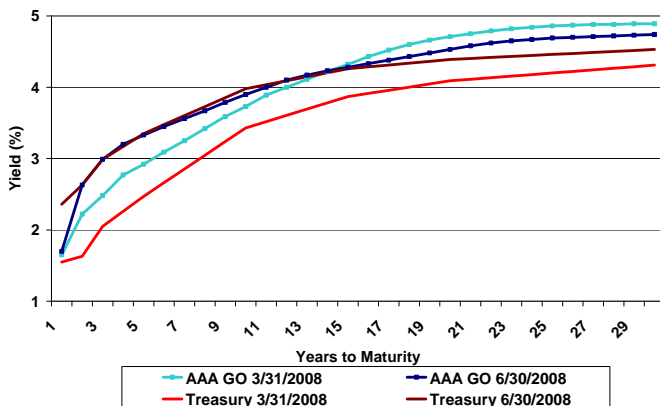
Early Calm, Then Renewed Credit Fears

The quarter began with a rapid reversal of the flight to quality to U.S. Treasuries that occurred in the first quarter. Credit fears eased as the Federal Reserve and U.S. Treasury Department came to the rescue of investment banks with lower rates and increased liquidity facilities. The perception that the credit crisis had passed, compounded with increasing inflation fears and a weaker dollar, caused interest rates to rise significantly. This trend continued until the second half of June when once again, weak economic data dominated investor sentiment and renewed fears of financial deterioration arose. By the end of the quarter, the flight to quality returned and U.S. Treasuries once again became the asset of choice. For the quarter however, spread sectors in general outperformed Treasuries, despite the flight to quality at the end of June.

Yield Curve Whipsaws

The frequent shifting market perceptions, rise in Treasury yields, and changes in Fed Funds Futures rate expectations, caused the shape of both the Treasury yield curve and municipal yield curve to change course several times. At the end of the quarter both yield curves had flattened with short and intermediate maturities rising more than long maturities in Treasuries and municipal long yields falling. Once again, municipal bond yields reached very attractive levels, both on an absolute level and relative to Treasuries.

Yield Curve Changes in Q2-08



Source: Thomson Municipal Market Data.

Municipal Market Update

The municipal market experienced a fairly volatile quarter. Demand was generally solid as dealers and investors bought bonds in anticipation of strong seasonal cash inflows from June and July coupon payments and maturities. Municipal bond funds also reported very solid inflows indicating strong retail demand. Nevertheless, municipals remain cheap compared to their historic relationship to Treasuries. In large part, this reflects the fact that Treasuries continue to benefit from the flight-to-quality trade while the municipal market is still dealing with the demise of the

bond insurers. Although widely expected (and in our view not material to the credit quality of the vast majority of municipal issuers), the downgrades of MBIA and AMBAC clearly put some downward pressure on the municipal market in June. The short-term market for Variable Rate Demand Obligations (VRDOs) was the most negatively impacted. Fearful that further downgrades would threaten liquidity, institutions put back many insured VRDOs causing rates on those issues to spike higher. As with Auction Rate Municipals, the solution for many issuers will likely be to convert to fixed rate long-term bonds. This could add supply pressure to the long end of the market, which may account for some of its weakness in June.

An additional challenge was created by the potential change in Moody's ratings to a Global Rating Scale. As we have written before, with the widespread use of municipal bond insurance, many investors had come to rely on the credit of the insurance companies and ignored the underlying issuer. As a result, there was little differentiation between issuers. With the downgrade of most insurers, this has changed and the municipal market is now factoring in the differentiation of credit quality amongst various insured issuers. At the same time, Moody's has announced that municipals will be rated according to their Global Rating Scale that puts more emphasis on the long term stability of municipal bond credits. According to this methodology, many municipal credits would have credit ratings of Aa or Aaa, which could make credit differentiation difficult to detect by rating alone. We continue to believe that sound credit research will be important in the face of such of ratings.

Breckinridge Strategy

Moving to a More Barbelled Maturity Structure

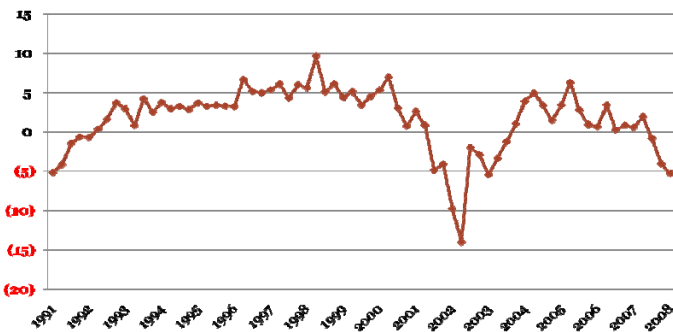
As we mentioned in our April and May newsletters, we anticipated that over the short term we would see yields rise, yet the rise in yields would prove to be short lived. We viewed, and continue to view, a rise in yields as an opportunity to purchase longer maturity bonds at attractive levels. Due to the uneven supply of bonds, we believe it better to purchase bonds as yields rise rather than try to buy as yields peak and demand will overwhelm supply. With the Federal Reserve currently on hold, and their next move most likely to be a rise in rates, we would expect to see a flatter yield curve with short rates rising. At the same time long term rates may decline slightly as the economy weakens. Accordingly, we are gradually moving to a portfolio structure that is more heavily weighted in both short and long securities. As opportunities arise, we are shifting out of intermediate maturity securities (5 - 7 years) and purchasing issues in the 10 year maturity range.

Credit Outlook for States/Municipalities

Challenges and Opportunities

The states and some local governments will be facing another challenging year in the fiscal year beginning this month. Housing market woes, leading to slowing income and consumption growth, are contributing to budget gaps for nearly 30 states. State tax revenues grew nominally 2% year-over-year in the first quarter, the slowest pace since early 2003; and when inflation and enacted tax cuts are taken into account, revenues actually declined 5.1%.

Real adjusted state tax revenue, 1991-2008
Percent change year-over-year



Source: Presentation by the Rockefeller Institute. Center on Budget and Policy Priorities.

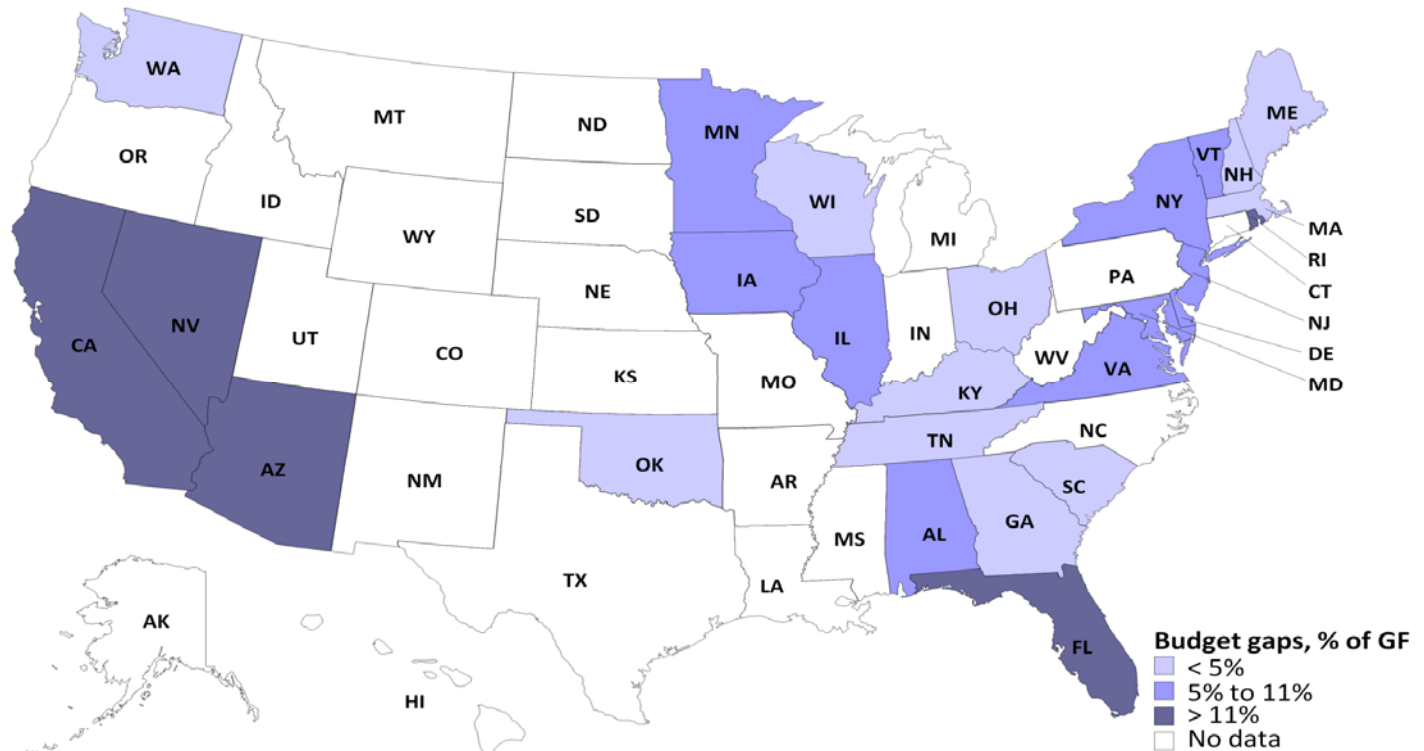
Moreover, the states are experiencing inflation for purchased goods and services that exceeds the rate for the national economy, possibly due to an overweighting of

petroleum-based spending (e.g. gasoline for vehicles and asphalt for paving) and higher employee benefits. Since the states generally are required to balance their budgets each year, tough decisions lie ahead.

As the chart below shows, four states – California, Nevada, Arizona and Florida – are reporting budget deficits amounting to over 11% of expenditures.

Still, as in most volatile markets, selective opportunities will be available with sound credit analysis. Since 2003, the states average fund balances have grown to an estimated 8% of expenditures at the close of FY 2008 from just over 3%. Although those balances are expected to be modestly drawn down in FY 2009, the cushion will remain nearly two percentage points above the average of the past 30 years. The states also are tightening their belts: on an inflation-adjusted basis, 2009 budgets will fall 2.4%.* It is this fiscal flexibility that has supported stable state ratings over the years. Standard and Poor's has downgraded only three states to the BBB level and each recovered its "A" rating within three years. In fact, the spread widening that accompanied California's 2003 downgrade created an exceptional opportunity to lock in attractive yields as the credit improved. To be sure, some regions have been hit harder by the housing crisis than others, and tax receipts may take longer to recover in those areas. We will remain diligent as we maintain our risk-averse profile.

* Source: National Association of State Budget Officers



Source: Presentation by the Rockefeller Institute. Center on Budget and Policy Priorities.