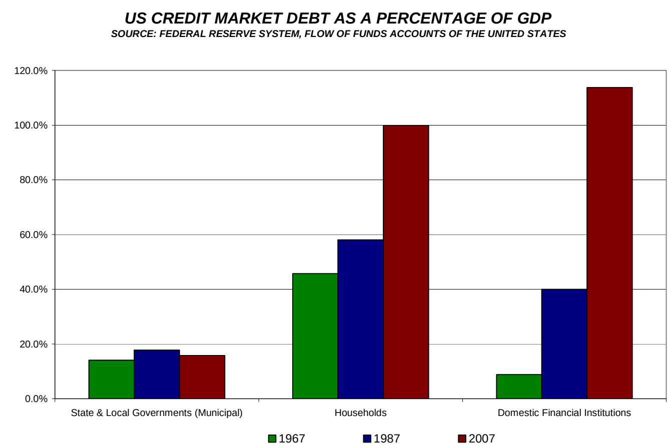
Financial Market Turmoil – What Has Happened to the Municipal Bond Market?

As we have stated many times; through periods of economic instability, wars, depressions, etc., municipal bonds have proven to be exceptionally reliable investments. While currently there are some unique challenges facing the municipal bond market, and some municipal issuers, the fundamental security of municipal bonds remains very strong. We believe it is important to distinguish between municipal bond investments, and the complexities within the municipal bond market that are presently confronting investors. While municipal bonds historically provide a safe and reliable source of income and return of capital, the municipal bond market at times experiences periods of dislocation.

To reiterate- *we believe the fundamental security of municipal bonds remains very strong.* The most important and distinct fact underlying this view is that most municipalities are not over-leveraged. As the graph below illustrates, state and local debt as a percentage of GDP has stayed relatively constant, while debt in other sectors has exploded.



Growth of municipal debt is limited due to federal, state and local government restrictions on borrowing. Therefore, while a severe downturn in the economy may put extreme strain on municipal budgets, the level of debt for the overwhelming majority of issuers is very manageable. Moreover, the obligation to levy taxes to service that debt is secure. Additionally, municipal default rates are exceptionally low – and in the rare instance of default, recoveries have been strong. Overall credit quality of municipal bonds has been good.

Moody's default study for the period between 1970 and 2006 supports the low-risk profile of municipal credits. The cumulative default rate for all investment grade municipals is .07% compared to 2.09% for all investment grade corporate bonds.* In the general obligation and water and sewer sectors (which account for nearly half of Breckinridge's holdings), only a single credit experienced a payment default, and that shortfall was cured within 15 days.*

Along with their conservative financial profile, there are additional reasons for municipals' excellent payment history. A municipality's general obligation pledge can be enforced by a court-ordered writ requiring the borrower to levy taxes sufficient to pay debt service. Even in the unlikely case of bankruptcy, a state or local issuer cannot be liquidated or cease operations. Also, legislative and constitutional requirements (e.g., balanced budgets, rainy day fund deposits) frequently compel fiscal discipline. Municipal water/sewer and electric utilities generally have the flexibility to raise rates without approval from an oversight authority, and often have exclusive service areas shielding them from competition.

This combination of sound credit fundamentals – including modest leverage and conservative budgeting – and the foregoing legal, competitive and structural factors will help municipal bonds maintain their excellent record of bond repayment.

Why is the Municipal Bond Market Struggling Now?

There is a distinct difference between the current situation and past dislocations. Currently, the municipal bond market is in the painful process of unwinding much of the financial leverage put in place over the last three decades. As we have seen in the past few weeks, the smooth functioning of the global financial markets depends on the continuous operation of the short term credit markets. Municipal bond issuers and their financial advisors have relied extensively on the ability to issue short term debt to fund long term obligations. In an environment of consistently steep yield curves (short rates lower than long rates), it was cheaper for issuers to borrow at the lower interest rates found in shorter maturities. Issuers were encouraged to purchase derivative contracts that would "lock in" these savings while establishing a fixed cost of borrowing. A key factor that led to the problems in the municipal market was that borrowers relied on some sort of credit enhancement such as bond insurance and bank liquidity facilities in order to sell the bonds. As insurers failed and banks stopped providing credit, the smooth operation that worked so well for so many years came to a standstill.

Another factor causing additional pressure on yields was the emergence of leveraged investors in the municipal market. A common funding method, called a TOB (Tender Option Bond) used leverage in borrowing short term money to fund long term obligations. As credit and liquidity dried up and borrowing costs rose, these funds have been forced to unwind their programs – (sell long term bonds) thus putting even more pressure on an already stressed market.

BCA | BRECKINRIDGE CAPITAL ADVISORS, INC.
200 High Street, Boston, MA 02110 • Ph: (617) 443-0779 • Fx: (617) 443-0778
www.bondinvestor.com

What Can a Municipal Bond Investor Expect?

We cannot predict when the municipal bond market will right itself. The return of stability will depend on factors related to the overall health of the financial markets. We believe that the vast majority of municipal bond issuers will emerge from this turmoil intact.

Breckinridge was founded on the belief that it is best to own bonds directly. Underlying that belief is the recognition that markets are sometimes unreliable. What is reliable is the steady stream of income and capital from issuers with solid fundamentals. We believe it is important to emphasize that your funds are invested in tangible assets that provide essential government services for our country's future, and for valid and ongoing public purposes that continue to be supported by the government.

Quarterly Market Overview

The third quarter of 2008 will be remembered as a time of unprecedented change. The collapse of Wall Street accelerated dislocation and volatility in the financial markets. As the process of deleveraging and consolidation took its toll on banks and broker/dealers, the fallout on the credit markets was severe. Confidence was replaced by fear, and certain sectors of the financial markets froze as investors and dealers stepped aside in an unwillingness to provide needed capital. Even the once sacrosanct money market funds were impacted as the NAV on one of the oldest funds in the country fell below $1. Several different types of government intervention failed to stem the loss of confidence. The primary beneficiary of this fear was the Treasury market. Investors flocked to the safety of U.S. Treasuries, particularly short term Treasury Bills. Yields dropped to unprecedented levels of close to 0%, and yet on certain days in September the Treasury couldn't issue enough T-Bills to meet demand.

Source: Bloomberg

The intense financial market dislocation has accelerated tight credit conditions on a global basis. The financial deterioration and subsequent consolidation in the banking and broker/dealer sector has had a ripple effect. Corporations and municipalities have been unable to access the credit markets for funding; and small businesses and consumers have been unable to obtain loans from banks that are unwilling or unable to extend credit. This is leading to an acceleration of economic weakness; with rising unemployment, a housing market that has yet to stabilize, and a continuing decline in manufacturing. A positive effect is that inflation has also started to decrease as commodities fell sharply. This accelerating weakness may lead to a near term easing of interest rates by the Federal Reserve Bank, as evidenced in the current pricing of Fed Funds Futures.

Tax-Exempt Market

Municipals Hit By Many Factors

For the quarter, municipal bonds in general posted negative returns as the flight to safety caused yields across the maturity spectrum to rise well above those of treasuries. Performance was especially impacted in September when the Lehman bankruptcy temporarily disrupted market liquidity. The combination of market illiquidity, massive redemptions in short term money market funds, and increased concerns over rising budget deficits, resulted in sharp underperformance. We view this rise in municipal bond yields as an opportunity to lock in generous yields.

Taxable Market

U.S. Governments and Taxable Municipals Star Performers

Treasuries outperformed all other taxable sectors in the flight to quality. Mortgages, and notably, taxable municipals, then agencies performed well; all posting positive returns for the quarter and the year to date. The corporate bond sector was hit especially hard as the credit markets seized up, and worries of future credit deterioration increased.

Summary

The recent market turbulence, while at times uncomfortable, has not shaken our belief in the safety and quality of municipal bonds. We view the market dislocation as one of the rare opportunities to purchase select issuers at historically attractive yields.

* Moody's Investors Service, March 2007