

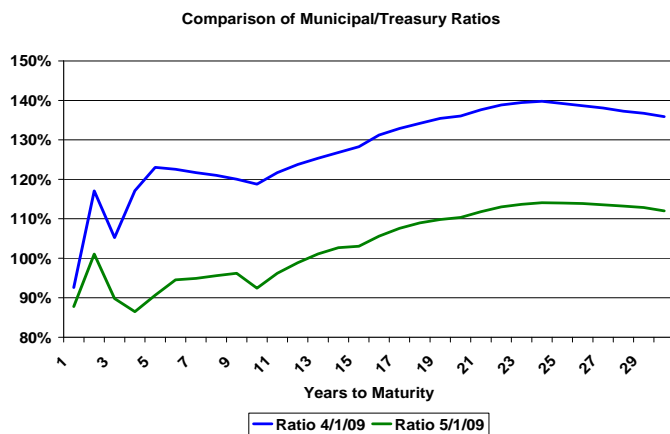
Market Overview

Treasury yields rose during the month of April reflecting a shift in investor sentiment. Concerns over increased treasury supply and signs of economic recovery resulted in a flight from high quality assets to riskier assets. Heavy treasury issuance was met with tepid demand, causing yields to rise, and negative returns. In contrast, tax-exempt yields declined and the sector outperformed treasuries.

Tax Exempt Market

Yield Ratios Decline

The solid performance of municipal bonds can be attributed to a more favorable balance of supply and demand. Demand has increased as flows into municipal bonds have been strong, with AMG recently reporting the second highest weekly inflow on record. This likely reflects some continued movement out of low yielding money market funds and treasuries. Demand also seems to be supported by a greater level of comfort among most investors with the overall level of municipal credit quality.



Tax-exempt municipal supply has been, and will continue to be, greatly impacted by the Build America Bond (BAB) program. Under this program, municipalities now have the option to issue taxable bonds instead of tax-exempt bonds, and receive a 35% interest subsidy from the Federal government over the life of the bond (Please see the Special Commentary on our website titled [Taxable Municipal Bond Portfolios](#)). There is a significant net interest cost savings for municipalities under the BAB program, particularly in long maturities. In April, as a number of high profile municipalities opted to issue bonds under this program, investors and dealers began to recognize its potential impact on supply. Municipal bond yields fell, with the biggest decline in longer maturities where there is likely to be a major shift in new issue supply out of tax-free municipals and into taxables. The tighter supply has already caused the

tax-exempt municipal yield curve to flatten. In addition, municipal bond yields along the entire yield curve have moved lower relative to treasuries bringing ratios closer to levels that are more consistent with historic averages. The chart illustrates this decline over the last month. Breckinridge believes this trend toward a flatter curve and lower ratios of tax free yields to treasuries is likely to continue.

Taxable Market

Spread Sectors Outperform

As treasury yields rose, corporates, taxable municipals and agencies outperformed and yield spreads narrowed sharply. Risk was rewarded with lower quality bonds outperforming high quality bonds. Agency spreads narrowed, however; not as much, and returns were muted. Corporate bonds were the top performers, and in a sharp reversal, the beleaguered bank and finance sectors posted the highest returns. Recent non-Federally guaranteed bank debt issuance (which has been met with strong demand) appears to mark a turning point in the corporate bond market revealing much improved credit conditions. Taxable municipal bonds also performed well relative to treasuries. Investor interest in the new BABs was (and continues to be) very strong, and most issues have posted strong performance with spreads narrowing dramatically.

Blended Portfolios

Changing Yield Relationships

Breckinridge believes the BAB program marks the beginning of a new chapter in municipal bond investing. While the Federal government remains committed to subsidizing municipal borrowing, it is clearly no longer wedded to doing so only by exempting municipal bond interest. Consequently, investors must recognize that the supply of tax-free debt is likely to shrink, diminishing the advantage tax-frees currently enjoy. As in the past, there may be periods when a higher after-tax yield is available by investing in taxable municipal bonds (or government agencies) in a particular maturity range. This will be especially true for investors in lower tax brackets.

To optimize after-tax income, Breckinridge has been managing "Blended" portfolios for many years. This requires ongoing input of individual client tax-rates from consultants, which Breckinridge then uses to assess after-tax returns in the market when buying bonds for the portfolio. The systems and processes Breckinridge have developed to customize portfolios provide this capability. Given the changing dynamics of the municipal market, we believe it's likely to become a critical part of municipal bond investing.