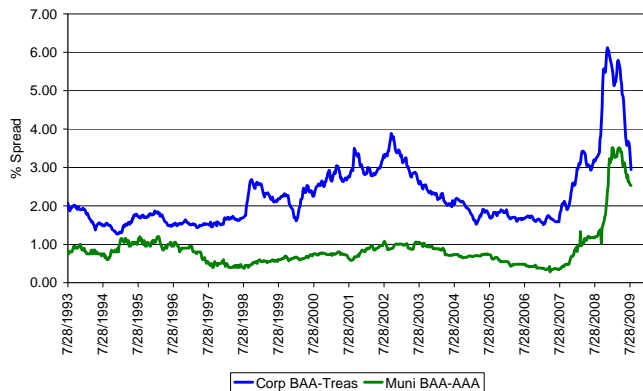


Market Overview

Lower Quality Bonds Outperform on Economic Data

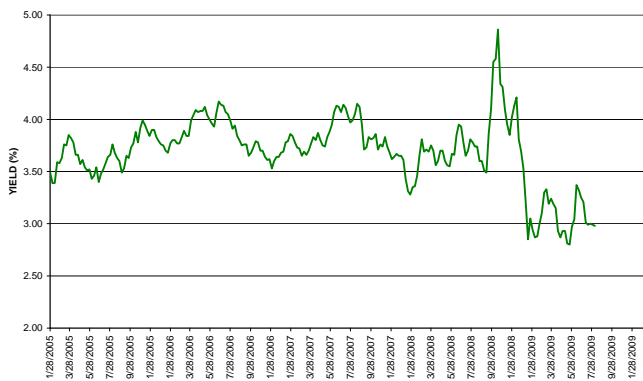
Financial and economic data released in July revealed stabilization and some improvement in the U.S. economy. Accordingly, investor sentiment turned increasingly optimistic and expectations of a second-half recovery grew. Strong returns in equities and corporate bonds last month reflected this optimism. In particular, lower quality bonds outperformed higher quality bonds as the appetite for risk among investors grew. For example, in the tax-exempt market, the state of California bonds posted strong performance in response to the state's budget resolution.

Comparison of Credit Spreads
Source: Federal Reserve and Thomson Financial



In the Treasury market, yields were volatile throughout July. The 10-year Treasury note traded in a range from 3.30 percent to 3.72 percent, ending the month at a 3.48 percent. Municipal yield ratios relative to Treasuries declined in July. Combined with lower Treasury yields at month end, the result was historically low absolute yields for municipal bonds, as shown in the chart below.

MMD AAA 10 YEAR MUNI YIELD
SOURCE: MMD



Market Outlook

Current Trends Appear Unsustainable

While the economy appears to be stabilizing, there are multiple economic forces working against a strong recovery including the high unemployment rate, decline in personal income, lower level of consumer spending, continued corporate cost cutting and the massive federal deficit.

In the absence of a strong recovery, outperformance of lower quality bonds is unlikely based on underlying

fundamentals. Default rates are expected to increase. Additionally, some investor profit-taking is expected in the fourth quarter. Still, technical factors – most notably the exodus from money-market funds – continue to push yield spreads lower. The abundance of Treasury supply also causes tighter relative spreads in other sectors. As a result, we expect continued volatility in fixed income markets and uncertainty in interest rate direction.

A Portfolio Strategy for Today's Environment

High Quality, Liquidity and Slightly Longer Duration

The market outlook for the second half of 2009 has clear implications for an optimal portfolio strategy in terms of credit quality, market liquidity and portfolio structure.

Credit Quality: Breckinridge continues to believe that high quality municipal bonds provide the best opportunities for maximizing risk-adjusted returns over the long term. We independently analyze the underlying credit quality of bond issuers, paying close attention to an issuer's debt burden relative to its resources. We continue to see opportunities in attractively priced bonds that have been "tarnished" with an inappropriate, generalized sentiment. For example, in states such as Michigan, Arizona, Florida or California, well-publicized economic woes have punished bonds of even solid municipalities.

Market Liquidity: Over the past year, pockets of illiquidity, which have always existed within the municipal bond market, have become more pronounced. Dealers have been either unable or unwilling to hold as much inventory. Additionally, some historically significant investors, such as insurance companies and hedge funds, have largely been absent from the market this year. This has exacerbated market illiquidity especially in longer maturities and has resulted in a steeper yield curve in the tax-exempt bond market. To counter this, Breckinridge continues to maintain a very broad dealer network including small regional firms that play an increasingly vital role in both the primary and secondary markets.

Portfolio Structure: We believe dueling inflation and deflation forces will result in ongoing market volatility and interest rate uncertainty. Thus, our overall interest rate outlook is fairly neutral. At the same time we expect the municipal market to benefit from strong demand especially for tax-frees, which will likely remain supply-constrained. Therefore, we continue to target a slightly longer duration with a barbelled portfolio structure. In a barbelled structure, longer maturities preserve returns in periods of deflation by locking in yields. Shorter maturities provide protection against inflation. Additionally, we continue to expect the yield curve to flatten in the third and fourth quarters. In this type of environment, a barbelled structure offers better risk-adjusted returns than a bullet structure. On an ongoing basis, Breckinridge actively manages client portfolios in the context of current and expected market conditions, moving opportunistically to enhance income and preserve capital.