

Market Overview

Search for Yield Drives Positive Fixed-Income Returns

Demand for intermediate- and long-maturity bonds continued to grow in August as fears of inflation receded and investors searched for higher yields. Money flows accelerated out of extremely low-yielding money-market funds into longer bond funds. As a result, both taxable and tax-exempt bonds posted positive returns, with the long-end of the market outperforming the average.

Other taxable sectors benefitted from the search for yield. Taxable municipals outperformed Treasuries in August, as did Agencies. Corporate bonds in particular delivered strong returns. However, corporate bond outperformance appears to be faltering, in line with weakness in equity markets. This trend could continue as corporate bonds historically experience spread widening in the fourth quarter.

BABs Limit Tax-Exempt Supply

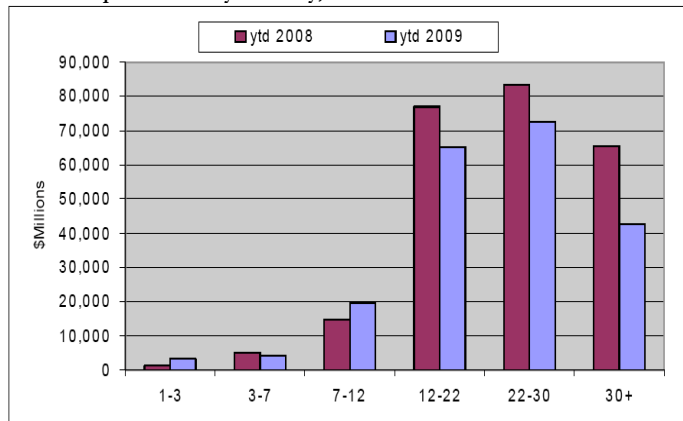
Creating Imbalance with Investor Demand

Tax-exempt municipal bonds also posted positive returns in August. For example, 30-year AAA General Obligation yields were 4.41 percent on Aug. 31, compared to 4.67 percent on Jul. 31. Positive returns were driven largely by a market imbalance in demand and supply.

In August, municipals benefitted from the same search for yield and receding inflation fears that drove demand growth throughout the fixed income market. We expect the Fed will keep interest rates low for quite some time, which will continue to fuel demand.

Supply of tax-exempt municipal bonds, however, remained limited in August. As shown in the charts below, the year-to-date issuance of Build America Bonds has sharply reduced issuance of tax-exempt bonds, especially in long maturities. We expect this trend to continue, as subsidized borrowing costs under the BAB program are lower than the costs of traditional tax-exempt bond issuance for most municipalities.

Tax-Exempt Issuance by Maturity, YTD 2008 vs. YTD 2009



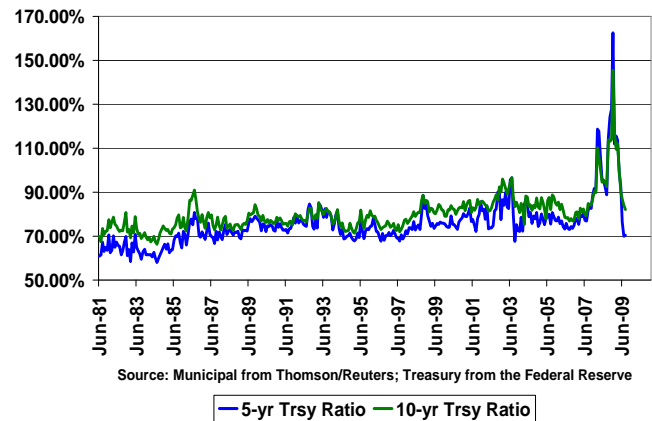
Source: Thomson Financial
 Provided by: Bank of America Securities-Merrill Lynch

Close Monitoring Required in Tax-Exempt Strategy

Traditional Relationships Shifting

Reduced tax-exempt issuance combined with ongoing outflows from money-market funds has generated significant change in the relationship between municipal bond yields and Treasury yields. For example, for a period of time in August, municipal yield ratios at the short-end of the market dropped to 55 percent of comparable Treasury yields. With yield ratios reaching low levels, it can be advantageous to purchase Treasuries or taxable municipals. The chart below depicts the changing relationship between municipal yields and Treasury yields.

Comparison of Municipal/Treasury Yield Ratio



Source: Municipal from Thomson/Reuters; Treasury from the Federal Reserve

— 5-yr Trsy Ratio — 10-yr Trsy Ratio

Shifts in traditional relationships such as these have clear implications for tax-exempt investment strategies. We expect the imbalance in demand and supply in the intermediate- and long-maturity markets may create opportunities for better after-tax returns in taxable municipals rather than tax-exempts. As a result, we are closely monitoring the relative attractiveness of tax-exempt versus taxable bonds within each client's portfolio based on their particular tax rate.

Leveraging BAB Acceptance in Taxable Strategy

Taxable Municipals Play Catch-up

We expect taxable municipals to continue to deliver strong performance. We believe there is room for additional spread tightening between taxable municipals and Treasuries. Additionally, acceptance of BABs by traditional investors suggests future demand could fuel continued outperformance of taxable municipals. Our taxable strategy is currently focused on relatively better yielding taxable municipals, especially given the historical weak performance trends for corporate bonds in the fourth quarter.