



MARKET COMMENTARY

May 2010

MARKET REVIEW

The Flight to Quality Continues

The flight to quality continued in May and risk aversion reigned. Treasuries benefitted and yields declined sharply. Fears centered on European sovereign default risk, the long-term viability of the euro, and most importantly, the negative impact of European austerity measures on the global economy. Despite the fact that U.S. economic data began to show slow growth, investors focused on the uncertainty of financial reform, which exacerbated risk aversion. Low inflation data and Federal Reserve Board commentary reinforced the view that the Fed will keep short-term rates low for a very long time.

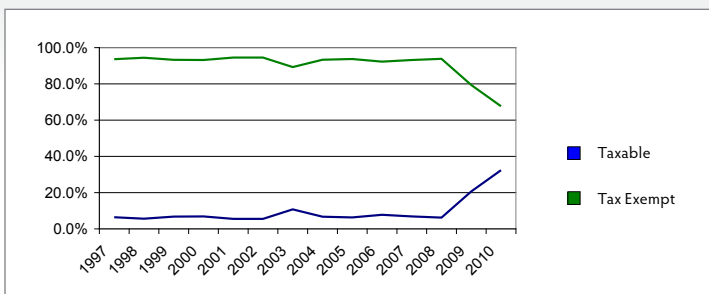
TAX-EXEMPT MARKET REVIEW

Risk Aversion Benefits High Quality

High quality municipal bonds outperformed lower quality bonds in May. Credit spreads widened to limit returns on lower quality bonds. While overall municipal supply was ample in May, tax-exempt supply was relatively low since a higher percentage of municipal debt was issued as taxable Build America Bonds (BABs). The chart below illustrates this trend. Low supply, combined with a steady inflow of funds provided support to the tax-exempt market. In a search for yield, funds continued to flow out of low-yielding money-market funds and into intermediate-maturity funds. Yield ratios relative to Treasuries also rose as Treasury yields declined significantly. On a relative basis, tax-exempt bonds continue to look attractive.

MUNICIPAL ISSUANCE: 1997 - 2010

Source: Bond Buyer Decade of Municipal Bond Finance



TAXABLE MARKET REVIEW

Taxable Munis Perform Well Despite Headline Risk

Rampant risk aversion drove widening yield spreads in all spread sectors in May. Corporate bonds, especially financials and energy bonds, were sharply impacted by the financial reform bill and the failure to contain the BP oil spill. Yield spreads on Agencies and taxable municipals widened modestly compared with corporate bonds. As in the tax-exempt market, higher quality outperformed.

The BAB program was the subject of several recent announcements out of Washington. The House of Representatives approved a jobs bill that included an extension of the BAB program for two years with a reduced subsidy. Additionally, the city of Austin, Texas and the state of Maryland announced the IRS withheld funds from a BAB subsidy payment for fees owed to the federal government. Finally, the IRS announced audits of some of the BAB deals to determine if there were any irregularities in the initial pricing.

We believe these issues will be resolved as the program evolves and regulations are clarified. Over the near term, however, uncertainty created by headline risk may put pressure on BAB yield spreads. We view any spread widening as a buying opportunity.

BRECKINRIDGE STRATEGY

Moving Out the Curve

It is becoming increasingly evident that the Federal Reserve intends to keep short rates low for as long as possible. Benign inflation data, a weak labor market, and weaker global growth support this position. With relatively steep Treasury and tax-exempt yield curves, we are buying in the intermediate part of the yield curve, and in some cases, swapping out lower yielding, very short maturities. This will result in a less barbelled portfolio structure. We are maintaining our emphasis on high quality given the uncertain economic and budgetary outlook.

THE UNFUNDED PENSION LIABILITY OVERHANG

Breckinridge Webinar Available on www.bondinvestor.com

Breckinridge recently outlined its strategy for navigating state and municipal pension risk in a webinar entitled "Pension Risk and Municipal Bond Investing." A recording is available on our website. Key points made in the webinar include:

- » Breckinridge believes pension obligations will contribute to significant divergence in the credit quality of municipal issuers in the next several years.

THE UNFUNDED PENSION LIABILITY OVERHANG, CONT'D

- » Funding ratios for major state and local pension funds are approximately 83 percent now and projected to decline to 72 percent by 2013, an inadequate level according to actuaries. Additionally, typical assumptions of 8 percent annual investment returns may be too aggressive.
- » However, most plans remain years from insolvency, which means there is time to pursue needed pension reforms. In Colorado, lawmakers recently passed legislation reducing annual payments to current retirees. In other states and municipalities, employees must

contribute more for the same pension benefits or wait longer to be eligible to retire. Pension reform has in fact become politically popular.

Assessing the diverging pension risk and credit quality of municipal issuers requires thorough, independent research. Breckinridge applies its proprietary credit rating system and individualized approach to assess pension risk – selling bonds that fail to meet our rigorous investment guidelines and buying only what we consider to be safe municipal credits.

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