



MARKET COMMENTARY

June 2010

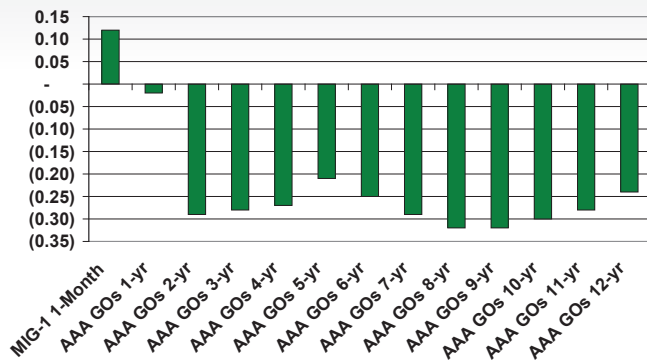
QUARTERLY MARKET REVIEW

A Quarter Marked by a Flight to Quality

The continued flight to quality in the second quarter was surprising in its strength and breadth. Fears of sovereign defaults, a global economic slowdown and disinflation dominated investor sentiment. Weak economic data led the Fed to reaffirm their intent to keep interest rates low for a more protracted time than earlier thought. The prime beneficiary was the U.S. Treasury market as investors fled riskier assets. Interest rates declined sharply and both the 30-year Treasury bond and 10-year Treasury note broke below psychologically important levels of 4 percent and 3 percent respectively.

CHANGE IN MUNICIPAL YIELDS FOR Q2-2010

Source: Thomson-Reuters Municipal Market Data



TAX-EXEMPT MARKET REVIEW

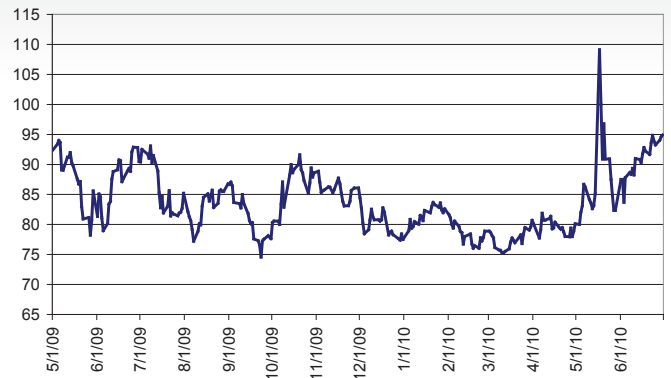
Positive Returns Despite Negative Headlines

Municipal-bond credit quality and fear of default were the subjects of numerous articles in the financial and popular press during the quarter. The number of negative articles increased as the June 30 budget deadline for most states drew near. Most of the articles focused on the macro picture of deteriorating finances and paid little attention to specifics. While it is true that many municipalities are fiscally stressed, we do not expect the wave of defaults that many have predicted. In fact, despite the negative press, the municipal market posted positive returns in the quarter as investors focused on individual issues rather than macro headlines.

Municipal bond yields declined in the quarter, but as is typical, they did not decline as much as Treasuries. In addition, the market has become increasingly bifurcated relative to credit quality. Spreads have tightened for higher quality bonds due to strong demand. However, spreads have widened on bonds from lower quality issuers and issuers with severe budget problems. With the sharp decline in Treasury yields, muni/Treasury ratios moved closer to 100 percent across the maturity spectrum. The fact that these levels have not been reached in more than a year has helped attract buyers to the muni market.

AAA GO 10YR/TREASURY 10YR YIELD RATIO

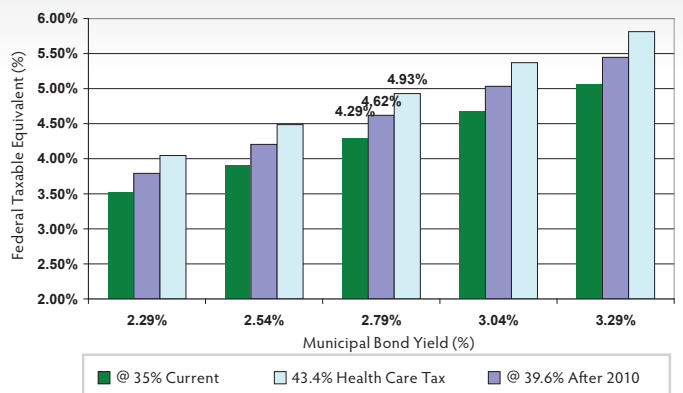
Source: Thomson-Reuters Municipal Market Data



When viewed on a taxable-equivalent yield basis, tax-exempt yields are attractive relative to taxable yields, especially when factoring in next year's expected higher tax rates. The chart below illustrates the relative attractiveness of tax-exempts at a 35 percent, 39.6 percent and 43.4 percent tax rate.

MUNICIPAL TAXABLE EQUIVALENT YIELDS

Source: Breckinridge Capital



TAXABLE MARKET REVIEW Long Treasuries Top Performers

The flight to quality resulted in outperformance of Treasuries for the quarter. Taxable municipal bonds outperformed corporate bonds during the quarter despite spread widening in the month of June. On a relative basis, taxable munis continue to yield more than corporate bonds; and we are maintaining our overweight position in Breckinridge portfolios.

We were disappointed the Senate failed to extend the Build America Bond program when the jobs bill was tabled in June. Resolution of the BAB program's fate will provide much needed clarity to market participants. We continue to believe the program will be extended, albeit at lower subsidy rates, given its substantial benefits to issuers and the municipal market as a whole.

BRECKINRIDGE STRATEGY Focus on Credit

Our strategy regarding portfolio structure and duration has not changed. We expect yields will be stuck in a low range for an extended period. As a result, we are targeting a duration that is slightly longer than the benchmark and a portfolio structure that is still barbelled, although not to the extent it was six months ago. In this period of fiscal stress, we are concentrating on specific credits or states and are being even more proactive in reducing exposure to certain issuers.

We address this topic in more detail in the following paragraphs and take this opportunity to examine some of the issuers that have been frequently in the headlines.

THE STATE OF ILLINOIS Fiscal Stress; Lack of Political Will

Illinois Comptroller Daniel Hynes didn't sugarcoat the state's financial woes in his July quarterly report: "Illinois ended (fiscal year 2010) in the worst fiscal condition in its history." June closed with a backlog of unpaid bills totaling \$4.7 billion, which could grow to \$6 billion. Normally the state has a two-month lapse period following the June 30th close of the fiscal year to clean up expenses, but given the size of the liabilities the legislature has extended the period to the end of December. Even with the extension the state will be hard-pressed to cover all the delayed bills. Governor Pat Quinn's budget anticipates \$1.3 billion of short-term debt, \$1.0 to \$1.2 billion of borrowing from other internal state funds and a \$1.2 billion securitization of the state's tobacco settlement funds, all of which perpetuates the state's history of one-time fixes. The FY 2011 budget forecasts total revenues of approximately \$27 billion or roughly 2 percent lower than the previous year. Total spending will increase by \$3 billion, or 10 percent above last year's budget. Illinois' growing pension costs are a significant part of the spending plan, amounting to \$4.2 billion. The legislature to date has not approved the governor's proposed \$3.7 billion pension issue; without the financing, pension expenses will begin to crowd out expenditures for other purposes.

Bondholders, though, have little to worry about debt service payments. According to the Civic Federation, a Chicago-based non-partisan government research organization, the state is committed to make required deposits into the General Obligation Bond Retirement and Interest (GOBRI) fund before paying other expenditures or transfers. The Civic Federation also notes that monthly cash flows in FY 2011 will range between 5.5x and 9x required transfers to the GOBRI, providing an ample cushion. Still, the state's debt load keeps growing. It ranked 14th in debt-to-personal income in Moody's 2010 state medians report. Illinois' leaders appear to be plagued by a lack of political will to deliver long-term budgetary solutions, especially with elections coming up in November. Headline risk and the potential for further rating downgrades will beleaguer Illinois until its politicians come to grips with structural fiscal changes.

During the quarter Breckinridge reduced portfolio exposure to longer-maturity State of Illinois bonds. We continue to closely monitor other Illinois credits.

GULF COAST OIL SPILL ANALYZING THE EVENT AND ITS AFTER-EFFECTS

The explosion of the Deepwater Horizon rig in April 2010 and subsequent oil spill in the Gulf of Mexico is an unprecedented ecological disaster. Breckinridge analyzed how the spill and its after-effects will impact the financial conditions of Gulf Coast state and local governments.

BP's clean-up activities appear to have stabilized many cities and towns in the region. As such, it is important to ascertain BP's ability to make good on all credible claims going forward.

BP PLC: ADEQUATE RESOURCES TO PAY ESTIMATED OIL SPILL LIABILITIES

Estimates of BP's spill-related liabilities vary but a recent approximation by research firm Sanford C. Bernstein pegged the aggregate cost at \$33.0 billion. BP has reported \$20 billion in current sources of liquidity and is expected to produce another \$21 billion in free cash flow over the next 18 months. Moreover, BP could pursue a number of strategies to enhance its cash position including asset sales, equity issuance and securing payments from its non-operating partners in the Macondo well. Overall, BP is likely to possess sufficient resources to cover the estimated level of liabilities.

Effect on Gulf Coast Municipalities: Short-Term Impact Manageable, Longer-Term Unclear

In addition to the positive effect of BP's remediation and claims payment efforts on Gulf Coast states and localities, municipalities are demonstrating proactive management practices. For example, officials of the City of Orange Beach, AL, recognizing a possible drop in sales tax revenue this summer due to the spill, successfully organized a temporary increase in property taxes to help maintain public services.

So the short-term impact of the spill appears to be manageable, but longer term, questions remain. For example: Will property values decline over time due to the oil's impact on the coastal environment?

Breckinridge's Response:

Assess Financial Conditions; Take Action Where Appropriate

Breckinridge responded to the spill by taking a comprehensive review of securities issued by municipalities in the Gulf Coast region. Bonds backed primarily by sales taxes, a more volatile source of revenue, were identified as most at risk. Those with historically stable but moderate debt service coverage or weaker reserves were sold.

The remaining securities are from municipalities with solid credit fundamentals, which affords them the necessary capacity to respond to this crisis.

As was demonstrated in the aftermath of Hurricane Katrina, municipalities can manage their way through epic disasters. Due to lingering uncertainties, however, we will continue to closely monitor our Gulf Coast-area holdings.

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