



MARKET COMMENTARY

March 2011

FIRST-QUARTER MARKET REVIEW

Interest Rates Increase, Uncertainties Abound

The economy continued to show signs of improvement in the first quarter, albeit at a slower pace than in fourth quarter 2010. Harsh weather and rising energy and food prices negatively impacted both business and consumer spending. Rising commodity prices eventually began to flow through to headline CPI data. With inflation expectations rising during the quarter, investors began to price in the eventual end of quantitative easing. Interest rates increased with intermediate maturities rising more than long maturities, which resulted in a flatter yield curve.

Investors continue to face myriad uncertainties and risks including global geopolitical risks such as Mideast tensions and the European debt crisis, Japan's nuclear disaster, unresolved U.S. and state budget deficits and rising commodity prices. Uncertainty is driving increased market volatility and the need for greater caution. We remain keenly focused on investing in higher quality bonds.

TAX-EXEMPT BOND MARKET

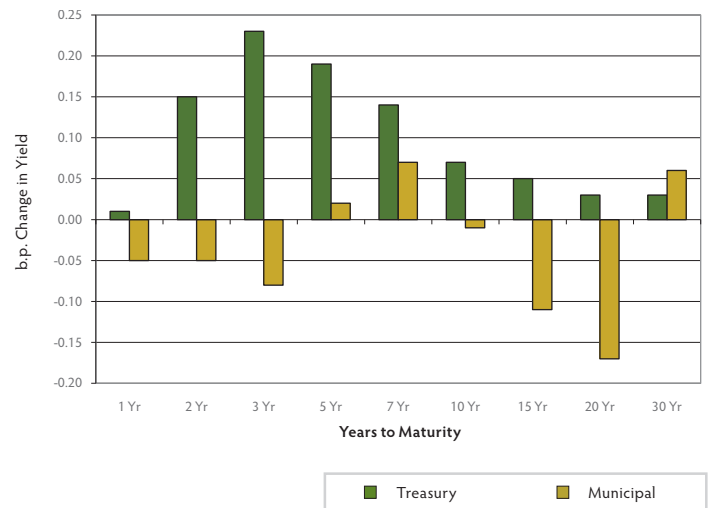
Lack of Supply, Outflows Drive Returns

The municipal bond market was characterized by two factors in the quarter: significantly reduced new-issue supply and continued mutual-fund outflows. First-quarter issuance hit a 10-year low and many analysts are estimating extremely low issuance for the year. Annual issuance typically runs between \$300 billion to \$400 billion and some estimates for 2011 are as low as \$200 billion.

Lack of supply helped support municipal bond returns in an environment of high mutual-fund outflows. Treasury and municipal yields diverged during the quarter. While treasury yields rose, municipal yields declined in certain maturities. As the following chart depicts, yields rose in maturities in the 5- to 7-year and 30-year range. Yields in shorter maturities declined, outperforming Treasuries. As a result, municipal/Treasury yield ratios declined in the quarter.

TREASURY AND MUNICIPAL YIELD CHANGES, Q1 2011

Source: Federal Reserve Board, Thomson Reuters Muni Market Data



Mutual-fund outflows accelerated amidst ongoing negative headlines about municipal credit quality. Funds have reported an historic 21 consecutive weeks of outflows. While Breckinridge is cautious relative to municipal credit quality, we are also optimistic in regard to the reforms that states are instituting in order to resolve their deficits. We are encouraged not only by the extent of reforms that are being accomplished in many states, but also by the speed with which some have been enacted. We have always contended that states have the ability and the tools necessary to resolve their fiscal problems. Political will is the key ingredient that is rapidly coming together throughout the nation. This month's Special Commentary addresses this subject.

Tax Reform and the Tax-Exemption Subsidy

Breckinridge has frequently written about the persistent technical imbalance of supply and demand in the tax-exempt muni market. We believe it is likely to continue and will contribute to market instability. This means tax-exempt yields will remain relatively high, and the market's capacity to meet the financing needs of states and localities will remain strained.

As a result, policymakers in Washington have questioned the merits of tax-exemption as a subsidy for municipal borrowing. Recent studies by

the Congressional Budget Office and the President's National Commission on Fiscal Responsibility and Reform offered alternative subsidy programs believed to be more efficient and less costly to the federal government.

Two separate tax-reform packages were recently proposed that would eliminate or threaten tax exemption for newly issued municipal bonds. Senators Ron Wyden (D-Ore.) and Dan Coats (R-Ind.) introduced a bill that would eliminate tax-exempt interest in favor of tax-credit bonds. Separately, House Budget Committee Chairman Rep. Paul Ryan (R-Wis.) introduced a fiscal 2012 budget resolution that contains a less-specific tax-reform proposal. However, it follows many of the tax proposals recommended by the President's Commission, which eliminated tax exemption for newly issued municipal bonds. While Breckinridge doesn't believe this bill, as currently proposed, is likely to become law, we do think the debate is very significant and will continue. In our estimation, there is a very real threat to the tax-exemption subsidy. In the context of any meaningful deficit reduction or tax reform, no investor should assume there will be continued supply of tax-exempt bonds in which to invest.

Clearly, elimination or restrictions on tax-exempt supply would have a very material impact on the relative performance of municipal bonds. Before a scheduled elimination of the tax-exemption subsidy, we would expect to see a significant amount of new-issue supply, which could temporarily raise yields. The subsequent lack of new supply would almost certainly lower yields and raise prices on existing tax-exempt bonds. While it would be premature to make a significant change in muni exposure based on this possibility, it is cause for concern. Breckinridge will continue to monitor the situation closely and engage in this important debate

TAXABLE BOND MARKET

Spread Sectors Outperform as Treasury Rates Rise

Both taxable municipal and corporate bond yield spreads tightened versus Treasuries during the quarter. Taxable municipals were supported by the lack of issuance due to the termination of the Build America Bond program. At the same time, corporate bond spreads tightened despite record-high issuance. Improving credit fundamentals and a search for additional yield drove strong investor demand. We expect both corporate bond and taxable municipal bond spreads to remain firm. We do however expect some issuer-specific widening within the corporate bond sector. Event risk is rising as shareholder-friendly actions and M&A activity increases.

BRECKINRIDGE STRATEGY

A More Defensive Stance

We have become more defensive in our portfolio strategy in terms of duration and remain cautious in terms of credit quality. Municipal credit concerns will remain in the media spotlight over the next quarter as municipalities grapple with their budget deficits. Breckinridge remains committed to rigorous fundamental credit research in these uncertain times.

We also expect new-issue supply to increase in the second-half of the year and it is unclear if demand will be able to absorb the increase – particularly in longer maturities. For these reasons, we are targeting a portfolio duration that is close to the benchmark; with an average portfolio quality that is higher than the benchmark.

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