



MARKET COMMENTARY
December 2011

YEAR IN REVIEW

Flight to Quality Rewards Bond Investors

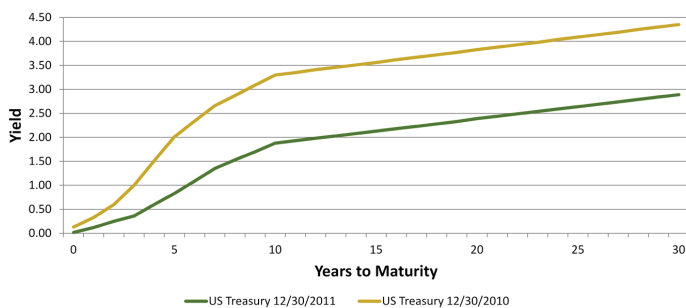
An extraordinary flight to quality drove fixed-income markets in 2011 as several factors generated risk aversion on a global basis. A European sovereign-debt problem became a crisis when fears of a Greek default spread to Italy, Spain and Portugal, threatening the viability of the European Union, the euro and the European banking system. At the same time, austerity measures in Europe and the U.S. hindered economic activity. Fears of a significant global slowdown dominated market sentiment.

Problem areas in the U.S. economy included weak employment growth, slow growth in consumer spending and an overhang in existing housing supply. Over the course of 2011, the Fed became increasingly determined to support the lagging economy by maintaining extremely low interest rates, and instituted unprecedented policies in order to do so. A political stalemate over the debt ceiling in June followed by Congress' failure to craft a budget deficit resolution in the fall produced a profound loss of confidence in political leadership. Congress' inability to effectively deal with the budget deficit was a primary factor in Standard & Poor's decision to downgrade the U.S. debt rating from AAA to AA+.

Despite the U.S. debt downgrade, investors made a sharp flight to quality to U.S. Treasuries, driven by the European sovereign-debt crisis and fears of a global economic slowdown. This flight to quality along with the Fed's explicit commitment to maintaining low rates through mid-2013 pushed yields down. The yield curve flattened sharply with long rates declining more than 135 basis points and the 30-year Treasury bond returning more than 35 percent for the year. In many cases yields hit record lows across the yield curve.

US TREASURY YIELD CURVE COMPARISON AS OF 12/30/11

Source: MMD AAA/S&P



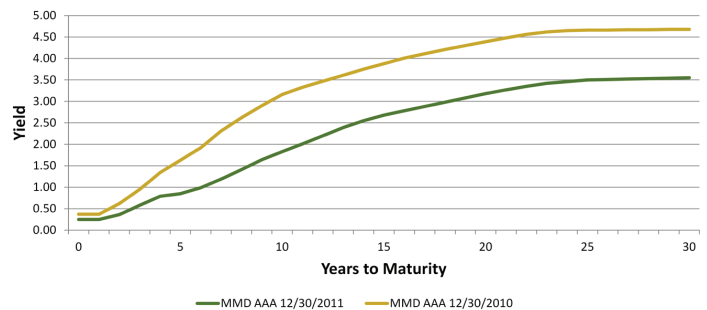
TAX-EXEMPT MARKET

Munis Outperform Despite Unprecedented Headline Risk

The municipal bond market posted one of its best years ever in terms of total return, benefitting from the flight to quality to U.S. Treasuries. Much to the surprise of many market observers, yields declined across the curve and the muni yield curve also flattened. This occurred despite many obstacles including the much-publicized dire prognostications by

MUNI YIELD CURVE COMPARISON AS OF 12/30/11

Source: MMD AAA/S&P



one market analyst who projected billions of dollars of municipal defaults in 2011. This prediction spooked municipal bond investors and spurred a record 29 consecutive weeks of mutual fund outflows in the first half of 2011. Other headwinds included new-issue supply concerns, state and local government budget deficits and declining tax revenues, highly publicized municipal bankruptcies including Vallejo, Jefferson County, and Central Falls, and possible changes in the tax code that would affect the federal tax exemption of municipal bond interest.

The muni market proved resilient despite these many challenges and could even be viewed as a safe haven during a turbulent year. Yield ratios relative to Treasuries remained high for most of the year, enticing crossover buyers into the muni market.

AAA GO 10 YR / TREASURY 10 YR YIELD RATIO

Source: Thomson-Reuters Municipal Market Data



Among the factors that led to relatively high yield ratios for the year were the decline in Treasury yields, strong technical factors including overall low supply and high demand later in the year, and a change in perception about municipal credit quality as budget deficits were resolved and revenues increased. This month's *Special Commentary* details factors driving the municipal market and provides our 2012 outlook.

TAXABLE MARKET REVIEW

Treasuries and Taxable Municipals Outperform

Treasuries outperformed all other fixed-income sectors for the year as risk aversion dominated. Taxable munis also performed very well and our portfolios remain overweight in taxable municipal bonds. Taxable muni performance was due not only to a lack of supply but also to their status as a relatively safe haven. Taxable munis are not subject to the same concerns that surround corporate bonds or mortgages, and they are viewed by many as an alternative to corporate bonds. Corporate bonds were affected negatively by concerns of rising event risk and the overall earnings outlook. The bank sector was affected negatively by European contagion fears and ongoing regulatory uncertainties, which in turn affected the corporate bond sector as a whole. Breckinridge will continue to underweight the banking/finance sector in taxable portfolios until there is more clarity regarding future regulation.

BRECKINRIDGE STRATEGY AND OUTLOOK

Stay the Course with Caution

Given significant yield declines in 2011, year-end signs of economic improvement and continued uncertainty over a budget-deficit resolution, we have become a bit more cautious. While we are not seeing strong improvement in the economy, there are signs of stabilization and some improvement, particularly

in the all important employment and housing sectors. An election year, 2012 could add further uncertainty to investor sentiment if a dysfunctional Congress continues to kick many important issues down the road. Additionally, a resolution to the European debt crisis remains elusive, which will continue to weigh on market sentiment.

We also remain cautious in regard to municipal credit quality as we anticipate rising credit downgrades from the rating agencies in 2012. Unfunded pension liabilities will likely garner more attention as the focus turns to new reporting regulations that go into effect in 2013. Lastly, we expect the tax-exempt status of municipal bonds to become even more uncertain as politicians look for solutions to the budget deficit problem. This uncertainty could weigh heavily on the market, possibly affecting longer maturities more than shorter maturities.

With the Fed firmly resolved to keep short rates at current low levels, we see more risk in longer maturities and possibly a steeper yield curve next year. Renewed fears surrounding the budget deficit could cause long rates to rise – especially from today's historically low levels. Accordingly, we are targeting a neutral to slightly long duration relative to the benchmark, and focusing new first-quarter purchases in the shorter maturity sector. Seasonal municipal supply may be amplified this year with very light first-quarter issuance and heavier issuance from second quarter through the end of the year.

One of Breckinridge's core beliefs is that a portfolio with a balanced intermediate-maturity exposure of diversified, high-grade bonds represents a good solution in periods of market uncertainty such as this. We continue to monitor the pace of the economic recovery, the debt crisis in Europe, legislative and regulatory actions in Washington, the supply outlook and credit quality and will adjust our portfolio strategies as market conditions dictate.

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