Municipal Bond Philosophy

Most bond managers are content to roll maturities in a laddered bond portfolio. This seems to assume that the best day to sell a bond is the day it matures and the best bond to buy is the one at the next rung on the ladder. In contrast, we actively evaluate opportunities to generate extra profits out of each individual holding. Our objective is to proactively provide a mix of fixed income securities that offer current income consistency and opportunistic growth potential. We analyze the yield curve, interest rates trends, arbitrage potential and security structure.

Municipal bonds are one of the very few remaining investment frontiers that offer exceptional rewards for investors willing to investigate value and explore inefficiencies. Successful investing in municipal bonds also requires a willingness to capacity-constrain any value-added edge. We currently utilize four strategies in municipal bond management.

SUMMARY

Short Intermediate Conservative
Securities are high credit quality and typically double tax-exempt. We add value through an analysis of the optimum maturity to own and the proper mix of callable and non-callable securities.

High Quality Total Return
We examine structure (the cash flow parameters) to find extra return in mostly insured or AAA rated municipals through an analysis of call provisions, advance-refunding potential, sinking funds, extraordinary prepayment probabilities and yield spreads.

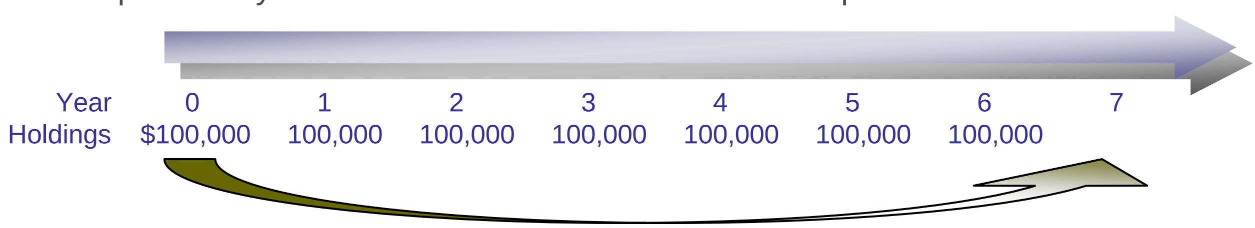
High Yield
Typical securities are non-rated bonds of small community projects (electric generation, water & sewer, etc.) Coupons often are higher and returns generally have less correlation to fluctuations in interest rates.

Closed-End Municipal Bond Funds
CEF's are listed on stock exchanges and often trade at substantial discounts to Net Asset Value (NAV). Contrarian profit opportunities can be substantial through a combination of spread normalization, above-average income and NAV appreciation.

Short/Intermediate Municipal Strategy

Doing More with Shorter Maturities

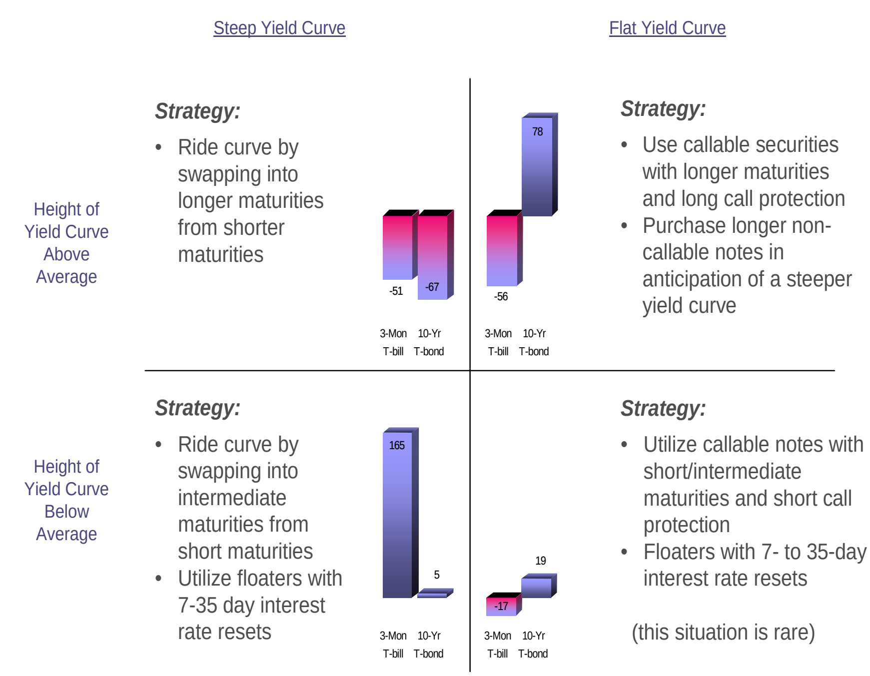
Most bond managers are content to roll maturities in a laddered bond portfolio. This passive approach is particularly utilized in short/intermediate-term bond portfolios:



In contrast, we actively evaluate opportunities to generate extra profits out of each individual security. This process involves an analysis of the slope of the yield curve, the inefficiencies across the yield curve, interest rate expectations, and individual security factors such as call provisions and geographic or sector supply/demand variables.

As an example, the chart on the right shows what strategy has worked best using two variables: the shape of the yield curve (the degree to which a longer maturity bond yields more than a shorter maturity holding) and the height of the yield curve (the absolute level of interest rates).

Sometimes callable securities make the most sense – other times non-callable bonds should be emphasized. Sometimes securities should be sold prior to maturity – other times they should be held to maturity.



Forthcoming Changes in Interest Rates in Basis Points
(source: Wainwright)

The securities used in the Short/Intermediate Conservative Strategy generally have an average rating of AA+ and are comprised of a mixture of callable and non-callable bonds. Average effective maturity is 1 to 7 years, depending on client preferences and market opportunities. Holdings are double tax-exempt in the state of residency, where appropriate.

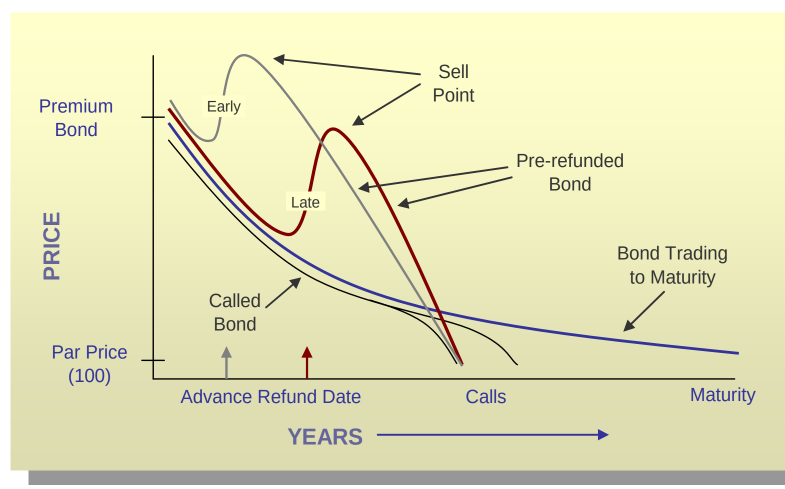
High Quality Total Return Municipal Strategy

Analyzing Structure to Bring More Return to the Bottom Line

This core strategy examines structure (the cash flow parameters) to find extra return in mostly insured or AAA rated municipals. We look at call provisions, advance-refunding potential, sinking funds, extraordinary prepayment probabilities and spreads to generic bonds. Consideration is given to the slope of the yield curve and the absolute level of interest rates. *Multi-state flexibility is usually essential. We typically favor negative convexity for its contribution to the strategy's objective of superior returns with low volatility in most environments.

One technique we use is to purchase bonds that can be advance-refunded (prerefunded). In normal environments they offer enhanced yield and lower volatility characteristics than generic par bonds. Yet they can add an additional 50-300 basis points of annualized return to the holding period because of the tendency of the bonds to leap higher in price at the time of the advance-refunding. The increase in price is due to the bonds reflecting the new US government collateral backing and the now certain (and shorter) maturity. This often provides an ideal time to realize profits, particularly in a positively sloped yield curve environment.

Advance-Refunded Bonds



Advance-refunding is a technique where a bond issuer replaces one bond issue with another. This typically occurs when a municipality can borrow at a more favorable rate – for example, when the general level of interest rates has come down or when a particular issuer's credit rating has explicitly improved or the market feels that it has improved. The new bond issue's proceeds are typically invested in US government bonds that implicitly guarantee the original issue. Once the call date of the original security is reached the government bonds are sold and the proceeds are used to redeem the original bond issue.

Other opportunities in high quality bonds occasionally make sense based on yields available or based on our estimate for future changes in interest rates. These include the purchase of non-callable, zero-coupon and other structures. Such alternatives may enhance capital appreciation in a declining rate environment or structure the portfolio for greater long-term income stability.

* Multi-state flexibility. Specific strategies need to be implemented with multi-state flexibility. This is due to secondary supply and ideal block size considerations. A multi-state portfolio means that interest on out-of-state bonds may be taxable to the investor at the state level except in states with no income taxes on out-of-state bonds. Normally the effective after-tax yield advantage of purchasing only generic in-state bonds is much lower than the return advantage of our strategy. As an example, since state taxes are deductible on federal tax forms and if the alternative is to purchase a generic in-state bond at a yield of 3.00% for an investor in a 30% federal tax bracket and 7% state tax bracket, an out-of-state bond would need to produce a yield of 3.15% (3.0%/(1-((1-.30).07))) to provide an equivalent return. We find this yield difference is often diminished or eliminated entirely by the reduced yields normally offered in specialty states (typically states with income taxes).

High Yield Municipal Strategy

Analyzing Credit Quality and Structure for Higher Return

Investing in high yield municipal bonds is an opportunistic investment approach that provides important diversification and risk management benefits. High yield municipal bonds have historically had low correlations to the equity markets and other fixed income securities and have produced returns substantially higher than has been achieved with traditional high quality laddered portfolios.

Typical high yield securities are either non-rated bonds of smaller community projects (electric generation, water & sewer, etc.) or below investment grade bonds.

Non-rated securities
Non-rated does not necessarily mean low quality – the bonds may trade at a higher yield simply because of the *smaller issue size and because many investors cannot or will not hold unrated bonds.

Below investment-grade securities
In contrast with non-rated securities, these issues are rated but the rating reflects credit-related risk as perceived by the *rating services. Opportunities are found in mispriced securities where comprehensive research demonstrates value or event-driven change. We value improving fundamentals, important management initiatives or merger potential. We look at competitive market position, interest coverage and revenue trends. Industrial and health-care are prominent sectors utilized.

Sensitivity to changes in interest rates

High yield municipal bonds are normally issued with high coupons, anywhere from 100 to 500 basis points over AAA rated bonds. They tend to have a low sensitivity to changes in interest rates. As such, fluctuations in market value are mostly a result of general market credit spreads and specific security credit quality changes.

This low and sometimes inverse correlation to traditional municipal bonds lowers overall portfolio volatility and results in consistent performance through volatile markets.

* Rating services, such as MBIA Insurance or AMBAC Financial Group, among others, provide insurance and financial guarantees to bond holders. Issuers generally pay an up-front fee to have their securities rated by one of the major ratings services. For small issues this is impractical and is the reason for many non-rated securities. This can also be an indirect reason for opportunities in below-investment grade securities – rating agencies receive no further fees to perform additional research and many times are slow to discover positive developments and management impact on issue fundamentals.

Closed-End Bond Fund Strategy

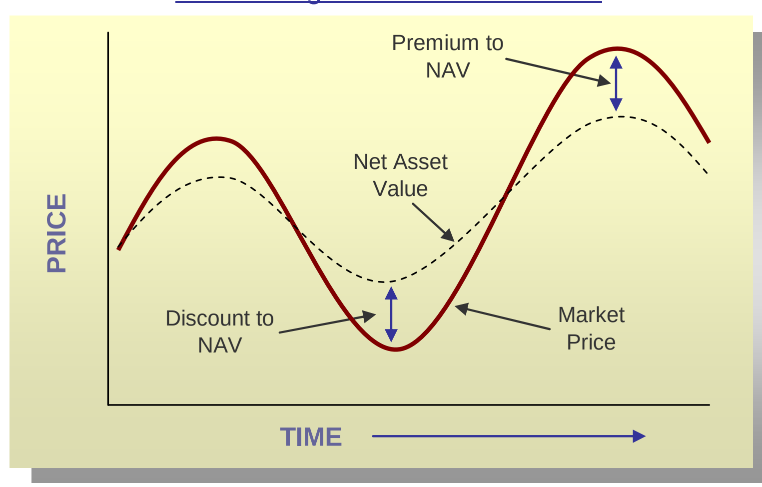
Higher Return Through Arbitrage and High Income

If you've ever worked for a company that allowed you to buy stock at a discount to its market price you'll appreciate one the key benefits to owning closed-end bond funds – the opportunity to purchase a quality investment at a significant discount.

Strategy. Closed-end funds (CEFs) trade at a premium or discount to Net Asset Value (NAV). When the investing public expects a rise in interest rates, closed-end bond funds can trade at substantial discounts to NAV providing contrarian opportunities to purchase at anywhere from a 7% to 15% discount. Total return profit potential can exceed 20% in some years through a combination of spread normalization, above-average current yield and NAV appreciation.

In addition to the discount, we look for funds that have above-average underlying performance and consistency of returns that span several different interest rate environments.

Purchasing at a Discount to NAV



Other closed-end fund advantages

- Because closed-end funds represent a fixed pool of assets, the portfolio managers can efficiently manage the assets with a long-term perspective. With bonds, this often results in a higher yield.
- Because we only buy funds at a discount the actual yield is significantly enhanced.
- CEFs usually have lower expenses because they do not incur marketing and distribution fees.
- They can be transacted just like stocks with orders placed throughout the day and limit prices specified.

Today there are over 450 closed-end fixed-income funds. They provide attractive opportunities to profit from tax-exempt, government, corporate, mortgage-backed and international bond investment.