

Tax Efficient Fixed Income

Period Summary

Investors are unaccustomed to seeing stories about credit markets on the front page of the press, despite the fact that credit markets are vast, dynamic, and underpin all other capital markets. Subprime mortgages, failed municipal auctions, downgrades, write-offs, and more have all contributed to turbulence, headlines, and concern over the past several months. The new-found attention given investment grade municipal markets creates opportunities for disciplined investors with a time-tested investment process that relies on fundamental credit research.

Short and intermediate high-grade bonds have performed well as the yield curve steepened and the Federal Reserve continued to drag short rates lower. Our bulleted yield curve position served client portfolios well in this environment. Longer bonds did not fare so well; for example, the Lehman Long Municipal Index return was -4.14% over the quarter. Treasuries continued to outperform, as foreign central banks bought aggressively to support the declining U.S. dollar, while domestic banks hoarded them to buttress their balance sheets.

Municipal prices have historically been less volatile than Treasuries – making them one of the safest investments available – but February was a most unusual month as municipal prices plummeted. What was so unusual about February was that municipal prices (and corporate prices too, for that matter) actually fell sharply as Treasury prices rose. In the five-year area, as one example, municipal yields increased 42 basis points during the month even as Treasury yields dropped 31 basis points. The total return on the Lehman Five-Year Index was -2.46% in February, while the Five-Year Treasury Index was $+1.75\%$. Longer maturity municipals performed even worse than the five year.

There are several reasons for this divergence between municipal and treasury performance; all related to the freeze-up of the credit markets. Numerous investors have shied away from municipals out of concern for the credit quality of the monoline insurers. We thoroughly research the credit quality of the issuer irrespective of insurance. The failure of the auction rate market added further uncertainty, and Treasury prices benefited from a global flight to quality. The largest reason, however, was the margin calls given to some very large leveraged municipal hedge funds that forced the liquidation of massive amounts of municipals during the last week of February. At month-end, high quality municipals were freely offered across the maturity spectrum at gross yields well above Treasury yields. We took advantage of the sell-off to lengthen the duration of our clients' municipals. Since the end of February, municipal yields have dropped 20 – 25 basis points in the intermediate range, but remain well above Treasury yields. It is now for investors to decide whether Treasury yields are too low, or if municipal yields are too high. Whichever way the question is resolved, municipals are certain to outperform Treasuries over the next year.

Period Highlights

- 1st quarter 2008 was a period of dislocation in credit markets

- Municipal prices fell as Treasury prices rose

Municipals Underperformed Due to:

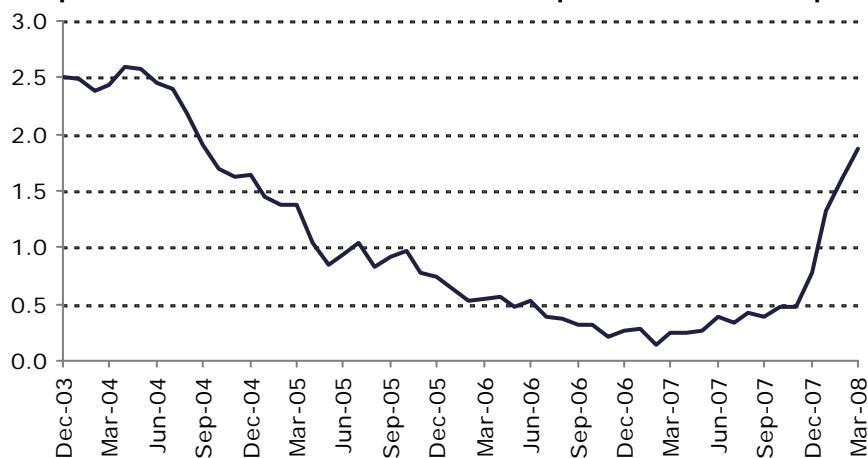
- Concern for monoline insurers
- Dislocation in Auction Rate Securities
- Liquidation of municipal arbitrage funds

One of the ironies of the present market is that uninsured municipals yield less than insured municipals, even if the underlying credit is exactly the same. We continue to buy stable and improving municipal issuers and will look through the insurance, or avoid it altogether.

On the last day of March, the Samson Investment Committee decided to further lengthen the target duration of our portfolios to approximately 110% of benchmark duration. This is less a statement about the direction of interest rates, than a reflection of our conviction that the cheap relative valuation of the municipal market is unsustainable. As a result, this is a prudent time to add yield and income to portfolios for conservative, income oriented investors. Depending on tax consequences, market conditions and the availability of municipal bonds that meet our credit standards, we will seek to move portfolios in this direction over the coming weeks. We believe that the value in the long-intermediate part of the curve warrants the marginal increase of risk.

Yet, extending duration at this point in time serves another important purpose – repositioning our portfolios along the yield curve. For several quarters we have maintained a bulleted yield curve posture. This reflected our belief that intermediate maturities would likely outperform while the Federal Reserve was reducing interest rates. Yet, in our most recent Investment Committee planning meeting, we reviewed the macroeconomic and market factors that shape our views and concluded that the Federal Reserve is near the end of its easing cycle.

Slope of the Yield Curve: 10 Year Municipal – 1 Year Municipal



As highlighted in the chart above, the yield curve, with 10 year municipals yielding 187 basis points more than 1 year municipals, is now the steepest it has been since 2004. This level was reached just prior to the Fed's tightening of the Fed Funds rate from 1%. Now that the municipal curve has steepened, we feel the time is appropriate to begin moving away from a bullet and to prepare the portfolios, in an incremental fashion, to begin moving towards more of a clustered strategy, and then a barbell.

Data Source: Bloomberg®

- Samson adheres to fundamental credit research and looks through to underlying credit quality

- Yield Curve Positioning: begin to move from bullet to barbell

- Yield curve steepened