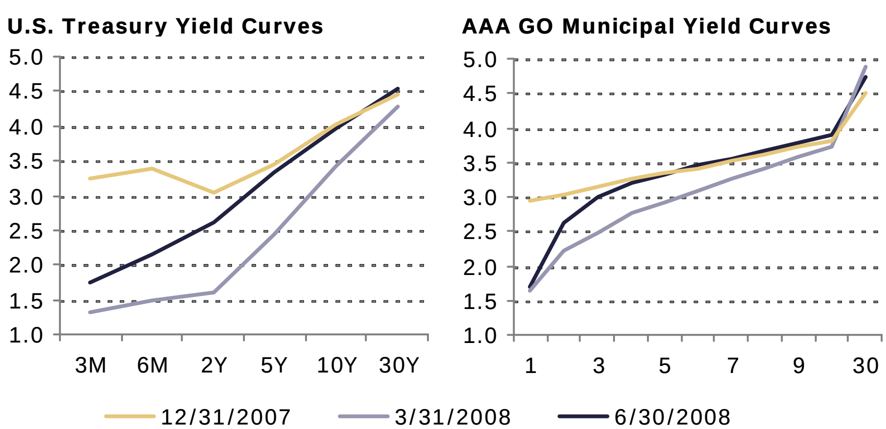
Tax Efficient Fixed Income

Period Summary

The painful unwinding of the Great American Credit Binge is entering its second year. The stock market decline reached bear territory late in the second quarter, with financial services companies under the most pressure. Bond prices declined modestly since March, as yields pressed higher when investors realized that the Federal Reserve could not push short rates lower without further weakening the U.S. Dollar and adding fuel to inflation. This was a replay of last year, where part of the gains of the first quarter was given back in the second quarter.

Short and intermediate-dated Treasury yields increased about one full percentage point over the quarter, as 1-3- year note yields rose from well below the Fed Funds Rate to well above. The effect of rising rates on portfolios was buffered somewhat by the relative recovery of municipals from the unrealistically cheap valuations reached in late February. Short municipal rates increased about one-half as much as Treasury rates in the shorter maturities, and rates actually declined for maturities greater than twenty years. This occurred despite unsettling news about municipal insurers and a continued decline in the financial condition of many state and local governments. These dynamics erased much of the oversold condition in the municipal market, but municipals represent good value relative to Treasuries. You may recall from our last update, we believe that "municipals are certain to outperform Treasuries over the next year." We hold to that view, although we were correct in less time than we expected.



Our strong views on municipals also contributed to the healthy performance of our high grade strategies for non-taxable entities, such as foundations and endowments. During the first quarter of 2008, we purchased municipal bonds in these accounts at yield ratios of up to 130+% of Treasury yields. As the relationship between municipal yields and Treasury yields normalized during the second quarter, the relative outperformance of municipals made an important contribution to performance and at the same time reduced the overall volatility of these portfolios during the period. We reduced our exposure to municipals in these accounts as the yield ratio between

Period Highlights

- 2nd quarter 2008 was a period of stock market decline. Financials stocks were under pressure. Bond yields increased modestly.
- Rise in Treasury yields outpaced rise of short and intermediate municipal rates.

municipals and Treasuries fell below 100% in June. We used the proceeds from our municipal bond sales to increase our exposure to U.S. Treasury Inflation Protected Securities (TIPS). While real rates remain low, inflation protection, as measured by breakevens, remains cheap.

For our core fixed income strategies our mandate from our clients is mainly preservation of capital. They consider their fixed income portfolio to be a counterweight to more volatile sectors of the capital markets, and in this regard it has served well. Still municipals are not totally immune from risk. This year saw more attention focused on upheavals in the municipal bond market than in any period since the Tax Reform Act of 1986. The first were the downgrades of the formerly triple A bond insurers. At the beginning of 2008, seven bond insurers were rated triple A, but by the end of June only two remained. Berkshire Hathaway entered the market as a triple AAA insurer; however, their participation is small relative to the size of the insured market. Today most bond issues trade at the underlying credit's valuation, which is what we at Samson have always looked at when purchasing bonds for our clients' portfolio.

- **Downgrade of AAA bond insurers**

The subprime problem and downturn in housing values are the next pieces in the municipal market saga. In those areas where property values have declined, it generally takes several years to see a major reduction in tax collections because of the length of time it takes to reassess mostly properties. Therefore, we would not expect to see a drastic change in credit strength. As for states, according to The Fiscal Survey of the States, just published in June 2008 by the National Governors Association and the National Association of State Budget Officers,

- **Lag time between declining property values and reduced tax collection**

> Revenues from all sources which include sales, personal income, corporate and all other taxes exceed expectations in fifteen states, are on target in fourteen states, and are below expectation in twenty states. This is a contrast to the previous year where only eight states reported revenue collections lower than estimates.

Countering this negative trend is the strength of state balance sheets, built up over several years of strong economic times. State general fund balances are projected to decline in approximately 7.5% of state budgets, which is slightly above the 5.8% average for the past twenty years.

- **Strong state balance sheets**

The third important event this quarter was the affirmation by the US Supreme Court of the status quo for in-state tax exemption for municipal bonds. The case, Davis vs. Kentucky, was widely followed, and even though the outcome had been predicted, it was still a sigh of relief to a market focused on the other two problems mentioned above.

- **US Supreme Court affirms status quo for in-state tax exemption for municipal bonds**

We are guardedly optimistic on the future of domestic stock and bond markets. How much of the credit problems have been addressed or written off is hard to determine, but we think more than commonly assumed. The labor market is likely to worsen, but export markets remain strong and the consumer continues to spend. Credit spreads and equity valuations are finally compensatory. On the down side, the United States policy makers – and ordinary people too, for that matter – are in a difficult position. Deficit spending policies combined with a chronically low savings rate have made traditional remedies – lower interest rates and fiscal stimulus – less viable and possibly counterproductive because they will encourage more borrowing and inflation.

We believe this period will prove to be an opportune time to add to municipal bond portfolios with intermediate term durations. The economic weakness will prevent sharp increases in bond yields, and pending tax increases will bring additional investors to the market, as will credit concerns in other markets.

Data Source: Bloomberg®

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