

Market Commentary

Period Summary

It would be difficult these days to be unaware of the dislocations in the economy and in financial markets. Stocks are down sharply this year, as are bonds issued by companies with even the slightest hint of financial stress. We view this period as the culmination of decades of poor management by business and government leaders, excessive consumer borrowing, and increasingly lax regulation. Derivative markets and off-balance sheet financing created opacity that, even now - eighteen months after the implosion of the two Bear Stearns hedge funds that launched the crisis - exacerbates the illiquidity and lack of confidence in the financial markets. There is ample evidence that the financial crisis has now spread to the broader economy.

The third quarter saw global stocks enter bear market territory and credit spreads widen significantly as safety of principal replaced the search for returns on investors' agendas. Municipal bonds, normally a safe haven in volatile times, were not spared. Intermediate bond prices fell 2-3 percent in September and long dated bonds fell over eight percent. Long dated, high grade municipal yields are now above levels that existed when the economy was still growing and the Federal Reserve was still tightening. In addition to a concern about an erosion of credit quality that would be typical during recessions, municipal prices were pushed lower by strong technical factors. The loss of five major market makers and the capital limitations of many of those remaining have hurt liquidity. More significant were the heavy sales from municipal arbitrageurs and the fear of additional sales from financially stressed corporate investors. Still, intermediate term municipal prices are higher when measured from the start of the crisis in May 2007, and, in that regard, Samson's bond portfolios have served one of their intended functions.

Due to these dislocations, municipal yields are 75-100 basis points over Treasuries in the 5 to 10 year range and 150-200 basis points over Treasuries in the long-end of the yield curve. These levels far exceed what would be justified by weakening credit alone. The liquidity challenges are likely to persist, or even deepen further, however when they eventually recede this period will likely be remembered as one of the most exceptional buying opportunities ever seen in the U.S. municipal market.

Credit Research Focus

Like most people, including those responsible for monitoring, rating and regulating banks and finance companies, we did not foresee the enormity of this current crisis. However, we were not unprepared. Since our firm's founding in mid-2004, it has been our belief that bond investors have not been adequately compensated for the risk of lower credit. Consequently, we selected municipal issuers that had sound demographics, were well managed, and had reliable sources of tax revenue. Our proprietary credit research looked past any insurance and focused on the underlying issuer. We invest in escrowed to maturity, general obligation, special tax and essential service revenue bonds. Within these sectors we prefer the larger issuers and names.

Period Highlights

- 3rd quarter 2008 ended with extreme financial market dislocation
- Credit spreads widened significantly
- Municipal yields rose due to credit concerns and diminished liquidity
- Samson's bond portfolios served their intended function
- Yield levels now exceed what would be justified by weakened credit alone
- It has been our belief that bond investors were not adequately compensated for the risk of lower credit
- Our credit research looked past insurance and focused on underlying issuers

The credit quality of some municipal issuers has already shown modest deterioration, as economically sensitive taxes from sales and income have declined in almost every state. We expect that trend to continue as the economy weakens. We are concerned but not alarmed by the development, and we have heightened our vigilance accordingly. Unlike the sudden death-spiral of Bear Stearns or Lehman Brothers, municipalities have revenues that are many times annual debt service requirements, and they have plenty of options (even if they are politically unpopular or painful) for managing expenses and postponing capital projects. In addition, many states have reserve funds from which to draw. Samson's credit analysts carefully vet the credits in our portfolios for these and other safeguards. The fundamentals of municipal finance – required balanced budgets, debt service payments, and active management - should provide investors with a degree of confidence during these times.

Data Source: Bloomberg®

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