

Market Commentary

Period Summary

The third quarter saw a sharp turnaround in the domestic bond market, as all sectors and all maturity ranges rallied. The panic of late 2008 continued to subside, and bond market returns correlated directly with credit and duration risk. Treasuries turned in pedestrian gains, but remain mostly down year to date. Municipals and corporates had another very strong quarter, with long-dated bonds producing double-digit returns. The high yield market was up almost 15%, and is now up almost 50% on the year. Stocks told a similar story. In short, investors rushed to purchase securities that they sold indiscriminately late last year. Investors who are desperately trying to rebuild savings quickly realized that the zero-percent money market rate engineered by the Federal Reserve was not the ideal vehicle. Flows into stock and bond funds have increased substantially throughout the year.

The strong equity markets and narrow TIPS and credit spreads suggest an inflation-free economic rebound. We would love to embrace such a view, but we see too many contradictions. Municipals have improved from apocalyptic pricing to relatively rich pricing over a nine month span, despite the lackluster outlook for municipal credits. Unemployment nationwide rose to 9.8% in September. State data, which lag national data by a month, saw four states hit their recorded historical high unemployment rates, but, on an encouraging note, six states that had hit their highs this year are now showing slightly lower unemployment. (See Table 1) Needless to say, we continue to be careful about the quality of bonds that we add to our clients' portfolio holdings.

Table 1

State	August 2009	Historical High	
Nevada	13.20%	Aug-09	13.20%
Rhode Island	12.80%	Aug-09	12.80%
California	12.20%	Aug-09	12.20%
Oregon	12.20%	Aug-09	12.20%
South Carolina	11.50%	Jun-09	12.10%
North Carolina	10.80%	May-09	11.10%
Florida	10.70%	Jul-09	10.80%
Georgia	10.20%	Jul-09	10.30%
Delaware	8.10%	Jun-09	8.40%
Kansas	7.10%	Jul-09	7.50%

Most states enacted balanced budgets for the 2010 fiscal year on time, with Pennsylvania, Connecticut and California among the exceptions. The personal income tax and sales tax, which are economically sensitive state revenue sources, were down in most states, so budgets had to be balanced by any number of measures, including state employee furloughs, cuts to programs, and increased tax rates and fees. While we believe that it is too early to accurately predict mid-year gaps, they are sure to come if state economies do not improve quickly. However, ratings on states remain relatively stable, with five negative (Ohio, Arizona, Illinois, California and

Period Highlights

- All sectors and maturity ranges rallied in the domestic bond market
- Municipals and corporates had a strong quarter
- Unemployment in some states reached their historic highs during the last quarter while unemployment rates in other states declined from previous historic highs
- State budgets were balanced by cutting programs, employee furloughs and increased taxes.

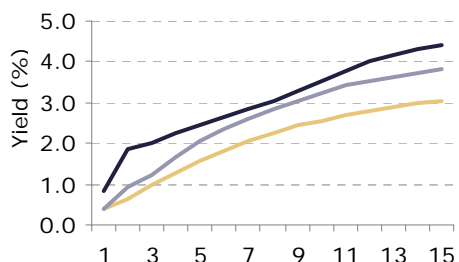
Idaho) and two positive (West Virginia and Texas) outlook or rating changes since June.

Many key municipal credit indicators (i.e. unemployment, property tax revenues and budget deficits) are known to lag observed returns in securities markets both on the way into and coming out of recessions. As a result municipal credits are expected to remain broadly pressured through the next year with the weakest areas not recovering for two or more years.

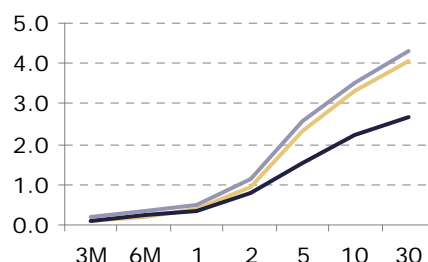
The Treasury yield curve steepened from year-end as yields increased in longer dated maturities, while municipal yields declined more evenly across the maturity range (See the Yield Curve charts below). Overall municipal supply has been low and the supply of longer maturity tax exempt bonds has been further reduced by Build America Bonds (BABs) issuance. The BABs were one of the more successful programs of the Federal stimulus package. Total BABs issuance through September 30th was approximately \$35 billion, which was greater than 15% of the total municipal bond issuance. Since most of the BABs were longer dated, greater than 20 years, their issuance helped contribute to the decline in yields in the longer maturities of the tax-exempt municipal yield curve. At the same time demand has been very strong from mutual funds and individual clients.

- Municipal credits expected to remain pressured
- Municipal issuance low although demand high
- Build America Bonds issuance reduced the supply of tax-exempt municipals and contributed to lower yields

Muni Yield Curves



Treasury Yield Curves



— December 31, 2008 — June 30, 2009 — September 30, 2009

The Fed began reflating two years ago, with the Fed Funds rate scraping zero late last year. The Fed is extremely good at this sort of thing, as we have seen during prior recoveries. In addition, the fiscal spigot has been wide open for over a year. Nevertheless, evidence of a U.S. recovery is hard to find: employment, consumer expenditures, bank lending and real estate markets remain weak and headline inflation low. Rather, the free fall into an economic abyss has been halted. Huge government borrowing demands, a rapid growth in the Fed's balance sheet, a pending reduction in the Fed's support for the Treasury market, and very low absolute interest rates convince us that the bond market is overextended. For these reasons, we are using the recent strength in the municipal market to keep the duration of our clients' portfolios short of our long term targets.

October 21, 2009

Data Source: Bureau of Labor Statistics and Bloomberg®

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