SAMSON
CAPITAL ADVISORS

Market Commentary

Period Summary

Skeptics have argued that the fixed income market is overvalued and prone to a significant rise in rates. Many of these investors, greatly influenced by the experience of the 1980's and the bear markets of the 1990's, view the current level of low rates as unsustainable. They argue it is better to wait on the sidelines in cash than stay invested in fixed income.

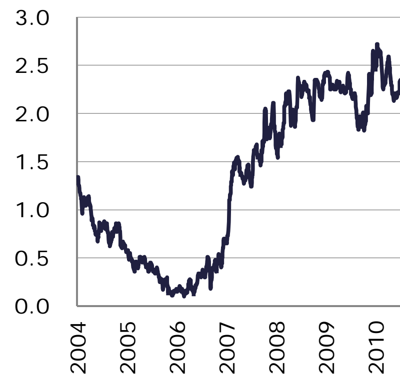
While we agree that certain long-term valuation measures suggest that fixed income markets are overvalued, we believe the current period of great economic uncertainty has no modern U.S. precedent. Our conclusion is that it is prudent to be modestly defensive from a rate perspective, but fully invested in the market. We enter the 3rd quarter with a duration target of 90-95% of comparable benchmark durations and a modest barbell position. Barbelled portfolios typically outperform in a flattening yield curve environment. As shown in the chart on the right, the municipal curve remains historically steep. We have also decreased our sector exposures to pre-refunded municipals and increased our allocations to various general obligation and revenue bonds as we believe the credit cycle in municipals has turned positive.

With regard to our rate outlook: We are in the camp that feels rates are likely to remain in a stubbornly low range for longer than many expect. We believe the following fundamental and technical factors are contributing to this extended period of low rates:

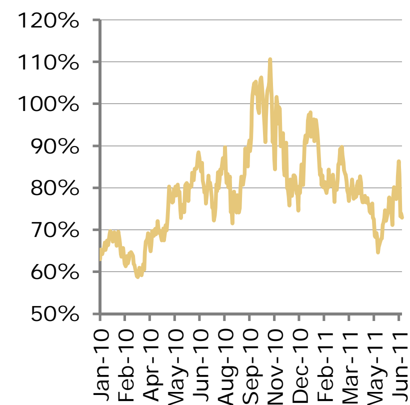
- The Federal Reserve's massive intervention in the bond market referred to as Quantitative Easing (QE), has kept a lid on interest rates. While the second round of QE has ended, the Federal Reserve will not actually be reducing its balance sheet. In fact, its policy is to reinvest maturities and other bond-related cash flows directly back into the market, leading us to believe that the Fed will be buying bonds for some time.
- The housing market, the epicenter of the crisis, has not recovered and has not shown signs that it will be turning around anytime in the near future. Until it does, a sharp rise in rates is unlikely.
- U.S. macro-economic fundamentals have remained tepid. It would be unusual to have a major bear market in bonds without tighter Fed policy. The Fed will not tighten when the character of the recovery remains unclear.

With regard to our sector outlook: Despite the increased austerity measures taking place at the local and state level, we believe that investment grade municipals remain a stable and reliable investment for those seeking steady income and long-term preservation of capital. Furthermore, with the sharp drop in Treasury yields due to equity market weakness and fears about Greece, municipal bonds have cheapened relative to Treasuries. As a result, we believe they are likely to hold their value better in a rising rate environment. The 5 and 10 Year Municipal/Treasury Ratio charts on the right show the increase of municipal yields versus the yields of comparable maturity Treasuries during the quarter.

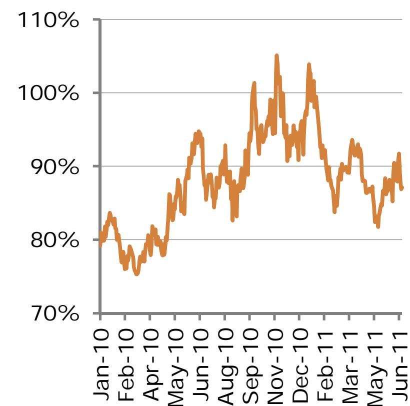
Municipal Curve Steepness: 10 Year – 2 Year Yield



5 Year Municipal/Treasury Ratios



10 Year Municipal/Treasury Ratios



Source: JP Morgan DataQuery

SAMSON CAPITAL ADVISORS LLC
600 LEXINGTON AVENUE, 20TH FLOOR · NEW YORK, NY 10022 · TEL (212) 300-1600 · FAX (212) 300-1650 · WWW.SAMSONCA.COM

While the low rate environment does pose a challenge with regard to income, we are concerned about the number of articles urging investors to reach for yield by investing in long-dated maturities (i.e. greater than 15 years). Many investors do not realize the inherent risk of investing at the long-end of the curve and we believe that this is a volatile strategy in the current environment as Treasury and municipal rates have dropped markedly since mid-February. It does not take a huge spike in rates for losses to occur when one is heavily concentrated in long-dated issues. As a result, we maintain a duration posture with a modestly defensive orientation.

For all of the concerns about municipals, the tax free bond market experienced healthy returns in the second quarter of 2011, as worries over the potential for widespread defaults eased and supply remained at historically low levels. The Barclays' Five Year Municipal Index returned 3.36% during the quarter. The drought in new issuance was influenced primarily by shifting priorities at the state and local level. Many state officials, particularly those operating in states with more difficult fiscal challenges, have been more concerned with cutting costs and raising additional revenue. They have deferred new projects and additional borrowing until truly necessary.

Most of the concerns surrounding the municipal marketplace earlier this year centered on default risk. Concerns about revenues, rising expenditures and the long-term liabilities of state and local governments further added to investor anxiety. Yet during the first half of the year, only 26 issues with a total value of approximately $818.2 million defaulted out of an estimated $2.9 trillion in outstanding municipal bonds. The majority of these defaults were special purpose, non-governmental issuers rather than bonds issued by essential service issuers providers or state and local governments. In addition, the fiscal outlook at the state level during the second quarter began showing some signs of improvement as year-over-year tax revenues, including income, sales and corporate income tax increased for the 6th consecutive quarter. While these tax revenues are still not at the peak level experienced prior to the recession, the upward trend, which can be seen on the chart to the right, is encouraging. As for the scrutiny involving unfunded pension obligations and other post-employment benefits (OPEBs), we are encouraged to see that 41 states have either proposed or enacted legislation in the past two years to begin to address pension and OPEB reform. From the beginning of the year, Samson has expressed our view that, while municipal issuers would have challenges, the claims in the media about imminent defaults which caused investor concern were overstated.

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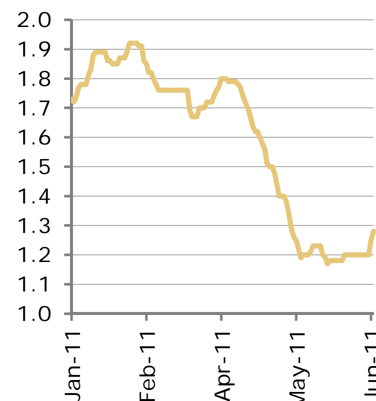
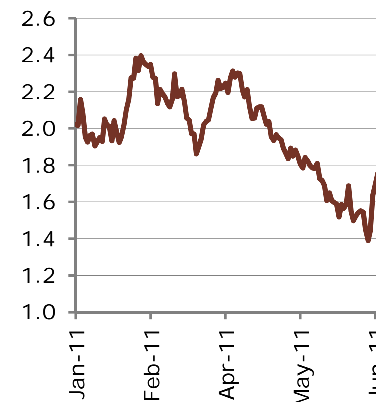
5 Year AAA Municipal Yields



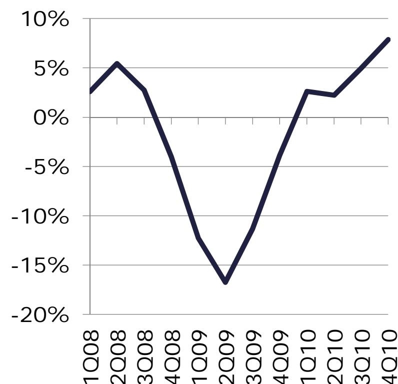
Source: JP Morgan DataQuery

5 Year Treasury Yields



Source: JP Morgan DataQuery

State Tax Collections: Year over Year Change



Source: US Census Bureau