CAPRIN Asset Management, L.L.C
Capital Preservation & Income

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7100 FOREST AVE., SUITE 303, RICHMOND, VA 23226

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Munis Perform Amid U.S. Struggles

On June 25th, the Federal Open Market Committee decided to leave the 2.00% Fed Funds Rate unchanged in the face of a stressed economy and a murky outlook. The FOMC statement expressed concerns for the second half of 2008 – namely, rising inflation (see *Figure 1)*.

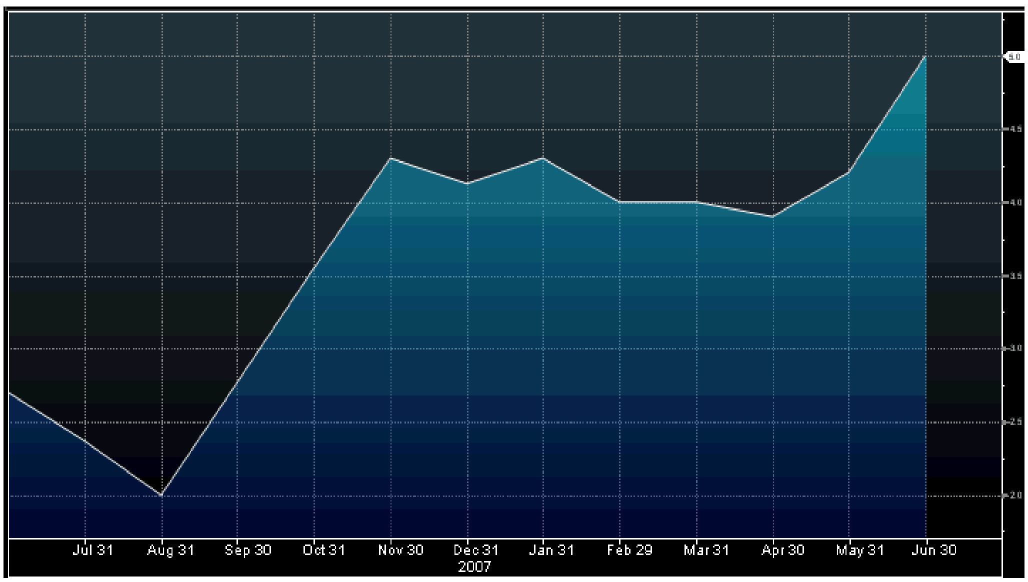

***Fig 1.** Headline Consumer Price Index (includes food/energy) in past 12 months* *Source: Bloomberg*

Uncertainty surrounds inflation in this country, and the Fed seems increasingly hawkish in its desire to keep rising costs in check. A commitment in the FOMC statement to action aimed at promoting price stability and economic growth was encouraging, but definitive near-term improvement in either realm seems unlikely. Fed Chairman Bernanke expects domestic growth to remain moderately positive for the foreseeable future, but as energy and commodity prices continue to soar, the downside risks of inflation remain a concern.

This financial market crisis has been generating more unsettling headlines recently; hence, we have witnessed exaggerated market reactions creating an even bumpier ride for investors. Several months may be necessary to sort out just how badly the financial industry has been damaged by the sector's recent liquidity issues, which have sparked a meaningful increase in U.S. job cuts. Heavy job cuts have surfaced quicker here than in Europe, whose economy is experiencing many of the same difficulties. Surrounded by so many uncertainties –

Highlights:

- Inflation becoming a greater economic concern as food and energy prices rise
- Federal Open Market Committee left Fed Funds rate unchanged as widely expected
- Caprin maintaining target duration close to 5 years, neutral to Lehman 7-year Municipal Bond Index
- Munis remain an attractive buy; market offering notable opportunities in longer-maturity bonds

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inflation, energy prices, the financial crisis, credit crunch, a struggling real estate market, and a new President – the equity markets have become increasingly nervous and may remain that way for the near future.

Despite the turbulence in equities and real estate, Caprin's state-specific municipal bond composite (an average of all qualifying portfolios) has performed respectably – up roughly 1.0% year-to-date – outperforming our benchmark index, the Lehman Bros. 7-Year Municipal Index. Relative to the S&P 500's negative 14.6% year-to-date performance, our composite has generated stability in this difficult environment.

Caprin Strategy

Global economic and financial concerns have most financial markets searching for answers as sensational headlines circulate about the struggles on Main Street and Wall Street. The first two weeks of July have seen unexpected concern surface over the health of Fannie Mae and Freddie Mac, the two government sponsored entities that serve as the foundation of our nation's mortgage system. Policymakers at the Fed, in Congress, and in the Administration have taken steps to restore confidence in these institutions, and we fully expect this will be achieved in the coming weeks.

Municipal bonds remain attractive, yielding close to – if not more than – 100% of like-maturity Treasury bonds. We have seen the differential in yields between longer and shorter bonds decrease since April, but longer bonds are still at yield levels considered historically high when compared to shorter maturity bonds. As a result, investors are being compensated sufficiently for the risk of owning bonds with slightly longer maturities.

Our portfolio strategy remains "neutral" to our benchmark, and we continue to manage to a duration target of about 5 years. While seeking opportunities in the 10+ year range, we balance that with investment exposure in the 2 to 3 year maturity range. In general, our portfolios have roughly equal exposure to short, intermediate, and long maturities at this point in the interest rate cycle. This structure positions portfolios to respond to and capture opportunities under several alternate scenarios as well as to minimize risk in a volatile and tentative market environment.

Managing risk in this environment naturally encompasses the quality of the municipality issuing the bond. We continue to favor, as we have for most of 2008, higher quality, liquid securities, particularly in longer maturity bonds. We have seen this group of securities perform well and continue to hold value during this unusual market environment. Municipal insurers have been generating headlines from time to time, and we continue to consider only those "insured" bonds whose underlying municipal issuer is creditworthy in its own right.

We remain constructive on the financial markets over the long term. As with any period of excess (the real estate bubble in this case), a reciprocal amount of time is required to work off the excess. Looking back over the past 30+ years, our economy and financial system have been able to recover fully and to move on to periods of improved returns. We fully expect a similar result to follow this episode in due course.