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2009—In Retrospect

Introduction

In 2009, a financial collapse of the world's most economically stable countries was averted and the healing process began. Investors reeled from equity losses of 28% during the first quarter while the banking system was on the verge of nationalization and the economy shed over two million jobs. By November, economists declared that the United States had emerged from the "Great Recession of 2009." Banks had repaid or planned to repay all TARP funds, equities had recovered almost 60%, and a glimmer of job creation had surfaced. Massive intervention by our nation's central bank and

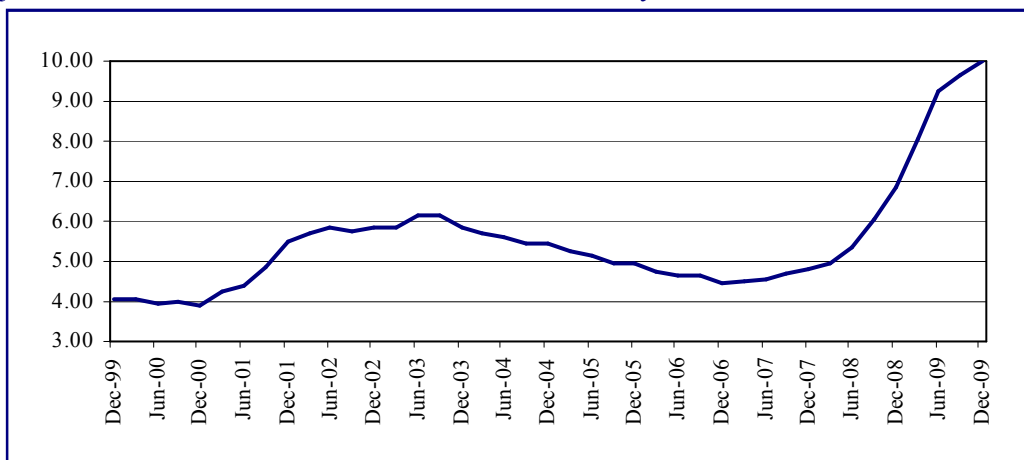


Figure 1. Unemployment Rate (%) as from 2000—2009

Source: Bloomberg

elected officials was instrumental in bringing the recession to an end and to preventing a financial meltdown. Initiatives such as the American Recovery and Reinvestment Act of 2009 are textbook solutions to filling the economic void left by waning consumer and business sectors. Other programs by the U. S. Treasury and the Federal Reserve to support the financial system, though, were admittedly in uncharted territory and continue to stimulate debate over the long-term ramifications. As we enter the New Year, several macroeconomic indicators are showing declining rates of deterioration and some small signs of hope while 'Washington' contemplates ending its fiscal and monetary accommodations in hopes of a consumer and business led recovery.

Two key factors will dictate the strength and pace of our recovery in the United States - the *Labor Market* and the *Housing Market*.

Labor Market

In November, the unemployment rate saw its first month-to-month decline since early 2007, encouraging expectations for 2010. However, the unemployment rate remains at 10.0%, just 0.2% better than the 26-year high touched in October 2009. It is often discussed that the U.S. economy remains woefully underemployed, meaning that many

Highlights:

- DATA INDICATES AN IMPROVING ECONOMIC ENVIRONMENT ARRIVED IN SECOND HALF OF 2009
- 2009'S "FLIGHT-TO-QUALITY" AND RELATIVE STABILITY IN MUNIS CREATED BEST MUNI PERFORMANCE IN 14 YEARS
- CAPRIN USING SHORT MATURITIES TO ADD YIELD TO MUNI PORTFOLIOS, VERY HIGH QUALITY IN LONGER-DATED BONDS
- CAPRIN MANAGING TO A NEUTRAL TARGET DURATION OF 5.0 YEARS

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jobless have either given up on finding a new job or have taken jobs well below their professional capacity. Individuals in these categories are not captured in the official tallies, thus the job market may require much greater rehabilitation in order to sustain a meaningful recovery. From a statistical perspective, improvements in the unemployment rate may be restrained as these individuals resume their searches and once again become part of the unemployment calculations. The number of jobless claims too may remain inflated. Many economists predict an unchanged to only a slightly improved unemployment rate by the end of 2010, suggesting an extended horizon for our recovery.

Housing Market

A record 14% of American homeowners are either behind on their mortgage payments or are in foreclosure, and the wealth erosion from tumbling home prices has been making headlines for close to two years. First-time homebuyer tax credits have helped nurture interest in the real estate market over the past several months -- home sales (as of December) were up almost 40% compared to the same time last year. Furthermore, many of the recent and projected home purchases are the result of foreclosure sales, which have helped work off inventory but to the detriment of home prices. With over 1.5 million homes in the queue for foreclosure, home prices should remain under pressure particularly if buyers remain in the 'wait for a better price' mode. Another cautionary perspective surfaces when considering buyer reaction to the reduction or elimination of the federal tax credit. Thus, the housing market requires considerable resources and interest to stabilize and begin a meaningful recovery of home prices.

Summary

While the labor and housing markets seem to be stabilizing, both will require patience in 2010 and beyond before normalizing. It took decades of reckless borrowing, spending, and speculation to create the financial environment we find ourselves in today, and a considerable rehabilitation period is required. We expect markets will experience periods of optimism only to be reminded that many Americans continue their struggle to rebuild their balance sheets and to improve their cash flow. In addition, the ability of investors to absorb risk in both the equity and real estate markets has clearly been tested over the past ten years, and we anticipate a shift in investor psychology over the next market cycle.

2009—A Review of Municipals

Introduction

Municipal bonds have garnered a great deal of positive attention since the start of the financial crisis as an attractive alternative to the highs and lows of the equity market. The arduous markets endured in 2009 forced many investors to seek the less volatile municipal bond sector as part of a "flight-to-quality." Municipal bond performance reached a 14-year best this year as a result of the preference for capital preserving assets. Surging investor demand coupled with the evolving fiscal outlook for many municipal issuers made finding bonds with relative value all the more challenging. With the prospect of higher taxes looming in the coming years, municipal bonds will likely remain in high demand for the foreseeable future.

Build America Bonds – The New Entity

The American Recovery and Reinvestment Act of 2009 introduced a new form of municipal debt early this year: Build America Bonds (BABs). BABs are taxable municipal bonds that provide the issuer with a 35% federal subsidy to offset the cost of issuing BAB-qualified debt in the taxable market relative to the cost of traditional tax-exempt issuance. This security class created an unprecedented dynamic in the supply/demand equation and had a direct effect on tax-exempt yields. Roughly \$64 billion of BABs were issued in 2009, compared to \$345 billion of traditional tax-exempt issuance. Thus, the amount of new tax-exempt debt available for investors to purchase was reduced as BABs often presented states and municipalities with a cheaper funding option. Because of the level of

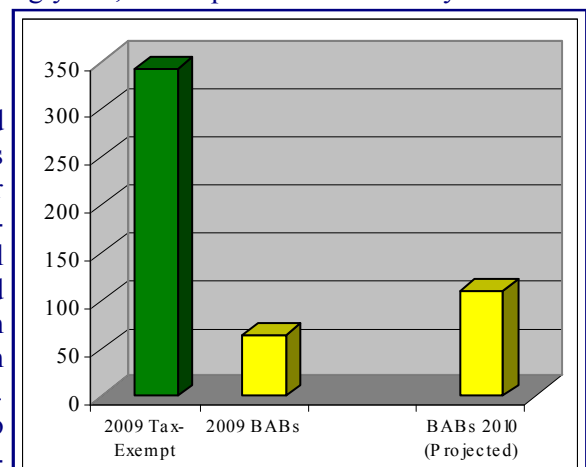


Figure 2. Municipal Issuance (\$B)

Source: MMD

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municipal bond yields relative to Treasury yields, issuers usually achieved more meaningful cost-savings by using BABs for longer dated bond maturities. With municipal demand at an all-time high and the lessened supply of tax-exempt securities, traditional municipals bonds were scarcer, especially in the 20 to 30 year maturity range, and yields were lower for retail/passive investors. This supply dynamic in longer maturity municipals forced municipal investors to look at short and intermediate maturities as an investment solution. The result was increased crowding and lower yields in short and intermediate maturities where Caprin typically invests the majority of client portfolios.

Going forward, Build America Bonds are likely to remain a preferred funding vehicle for tightly budgeted municipalities that can benefit from the cost-savings. BABs are projected to almost double in new issuance in 2010 compared to the \$65 billion we saw in 2009. If traditional tax-exempt debt issuance remains similar to 2009 as expected, then BABs will amplify their impact on the supply and demand equilibrium of traditional tax-exempt municipals.

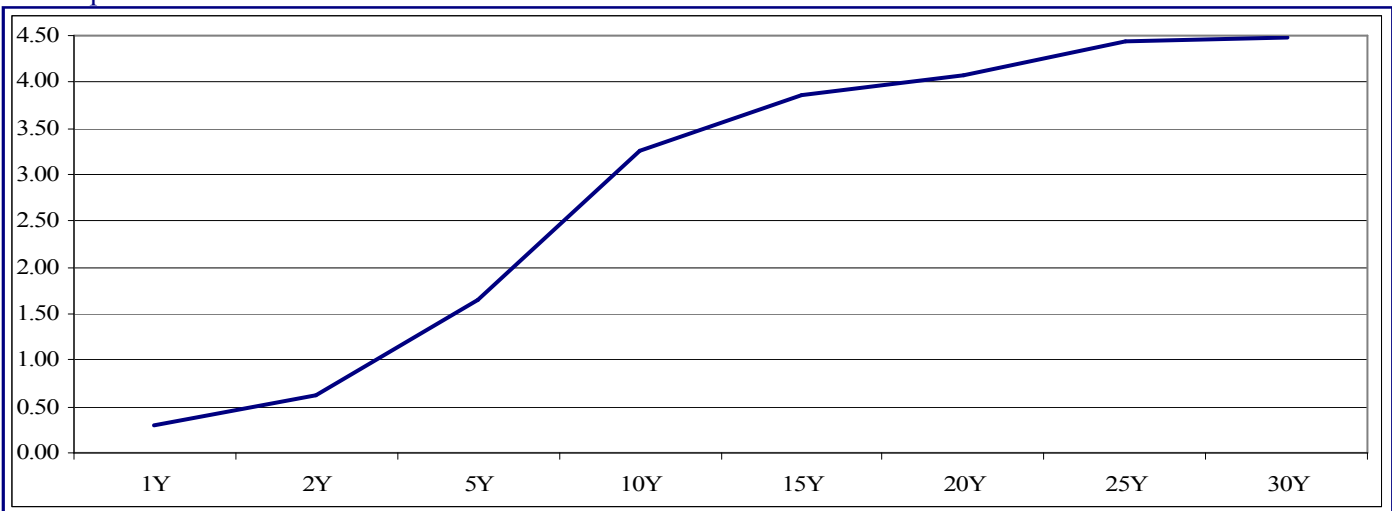


Figure 2. U.S. Muni G.O. AAA Yields from 1- to 30-Year Maturities as of 12/31/09

Source: Bloomberg

Caprin in 2009, 2010

Maintaining Higher Quality Bias

Anxiety over state and locality budget shortfalls was the topic of many discussions in 2009 and created a buzz in regard to some issuer's abilities to meet their debt obligations. Finances were stressed not only by constraints in traditional tax base and revenue sources but in some cases by the financial consequences of aggressive borrowing strategies. Some forecasters expect a rise in defaults of state and local general obligation municipals due to the extended time required to realign revenues and expenditures. We believe many of these worries are overstated, especially in the states and localities in which we invest client portfolios. However, securities of issuers in areas of greater economic stress may witness price and liquidity challenges as the market digests how effectively budgets are managed in 2010.

Caprin's emphasis on high-quality, low-volatility investments remains consistent for our client portfolios. We continue our credit surveillance of portfolio holdings, seeking to minimize event risk and unwanted volatility. Our investment discipline seeks higher quality general obligation and revenue bonds issued by essential purpose ('public works') entities to achieve these goals. We will assess the recovery in 2010, evaluating state and local fiscal conditions, and realign portfolios as needed.

Using Higher Yielding Sectors in Shorter Maturities

Municipals were one of the most sought after asset classes of 2009, and as a result, investors were forced to navigate inflated prices and lower yields. To combat the impact on portfolio yield, Caprin selectively complemented holdings with bonds that provided higher relative yields such as those issued by hospitals, power authorities, and other

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utilities. Investments were concentrated in shorter maturities to minimize the risk of time. As economic prospects improved, these sectors witnessed the return of an improving outlook resulting in positive performance and contributions to total return. As we enter 2010, our high quality and liquidity preferences complemented by selective yield augmentation remain at the core of our portfolio strategies.

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Looking back at 2009, we hope the lower-volatility and competitive performance of a Caprin managed municipal portfolio contributed to capital preservation during a period of turmoil and uncertainty. This period, which we have hopefully exited, reinforced the contribution of ongoing supervision, discerning scrutiny, and professional execution to achieving favorable municipal bond investment results. We look forward to 2010 and the ongoing relationship we have with you.

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this piece, will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion of information contained in this piece serves as the receipt of, or as a substitute for, personalized advice from Caprin Asset Management. To the extent that a reader has any questions regarding the applicability to their situation of any specific issue discussed above, they are encouraged to consult with the professional advisor of their choosing. A copy of our current written disclosure statement discussing our advisory services and fees is available for review upon request.