Review

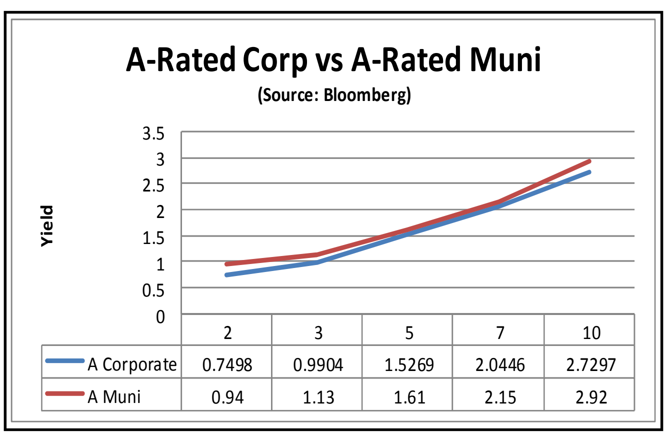
The Bond market rally continued this year with solid gains in the 2nd Quarter. Long treasuries were the strongest performer for the quarter as the problems in Europe continued to drive the yield on "safe haven" assets lower. High Yield continued to rally and was the best performer for the first half of the year. The current Fed zero interest rate policy is pushing investors out the curve and down in quality in

Muni Index	Duration	Return For 2Q 2012	Return For YTD
ML Municipal 3-7 Yr Index	3.99	1.07%	1.72%
ML Municipal 12-22 Yr Index	8.26	2.36%	5.06%
Taxable Index	**Duration**	**Return For 2Q 2012**	**Return For YTD**
ML U.S. Corp & Govt 5-7 Yr A Rated and Above	5.44	2.50%	2.86%
ML U.S. Treasuries/Agencies 7-10 Yrs	7.46	4.73%	3.21%
ML U.S. High Yield BB-B Rated	4.43	2.00%	6.51%

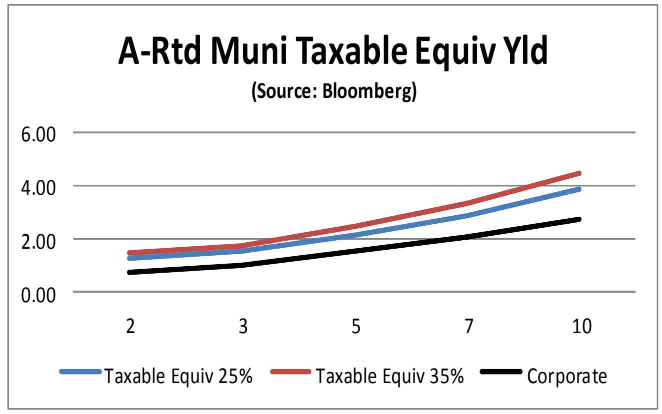
search of higher yields. We expect this trend to continue for the rest of the year. The returns for both the 2nd Quarter and the 1st Half of the year for a variety of indices are shown in the table above.

Finding Value In Munis

One of the best values in the fixed income markets today is in A-rated tax-free Muni bonds. The chart below shows a comparison between tax-free Munis and taxable Corporate bonds. Munis are actually cheaper than Corporate bonds



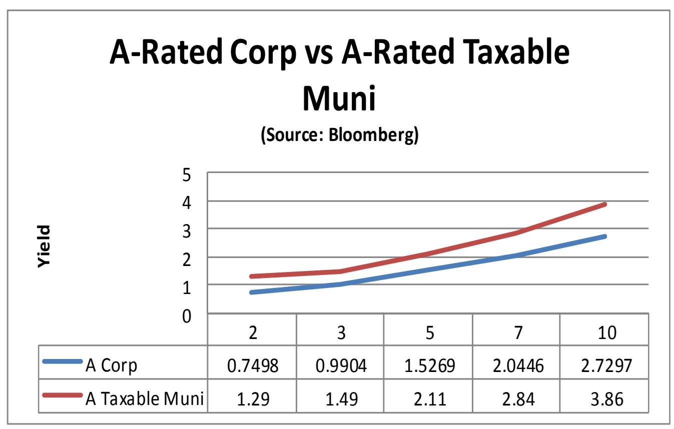
and are likely to outperform Corporate bonds in the future. We have recently been able to buy yields in the 3.00%+ range for A-rated Munis in the 10 year part of the curve. The table below shows the Taxable Equivalent Yields (TEY) for an A-rated Muni compared to a similarly rated Corporate



bond for taxpayers in the 25% and 35% brackets. A 10 year Muni yielding 3% has a TEY of over 4.60% for investors in the 35% bracket. This seems attractive compared to a 10 year Corporate yielding only 2.72%. We feel the additional credit risk of owning a safe sector A-rated Muni is very low compared to the additional after-tax yield that is available.

Taxable Munis vs Corporates

The chart below shows why we like Taxable Munis compared to Corporates for deferred accounts and low tax bracket investors. This chart shows the current yields available on



an A-rated Taxable Muni due in 10 years is about 3.86% compared to only 2.73% for a similarly rated Corporate. We feel safe sector Munis are better credits than Corporates, and we are able to pick up an extra 110 bp's of yield to buy the less risky bond. This is the type of risk vs reward we like, and is a good example of one of the market inefficiencies which exist in the bond markets. Taxable Munis represent about 5%-7% of the new issuance in the Muni market this year. During 2009-2010 this percentage reached over 30% due to the Build America Bond program which encouraged the issuance of taxable Muni debt for infrastructure needs.

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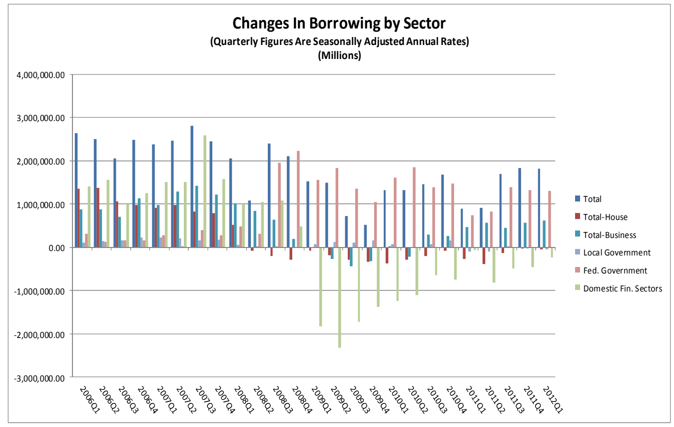
This program expired at the end of 2010.

Muni Credit Default Swaps (CDS): A Comparison
A credit default swap is a swap agreement that the seller of the CDS will compensate the buyer in the event there is a default on the loan, or some other credit event. CDS is an indication of the perception of credit risk in a security. The higher the value, the greater the perceived risk by investors of default. CDS for 5 different states are shown below. Currently the rate for the State of California is 184 which is

down from a high of 450 in December 2008. Market pundits were forecasting defaults for Munis in the Fall of 2008, and used the comparison below to show how risky Munis were. After all, they would argue, "CDS for the largest State in the U.S. is almost twice as high as that for Greece." The table below shows a comparison between CDS for the State of California vs several European Sovereigns for 12/12/08 and 6/30/12. In hindsight, it turns out that the pundits had their focus on the wrong credit. During the last 4 years the State of California has worked hard to balance it's budget by cutting expenses, raising taxes, and working with the public employee unions to reduce benefits and pay to levels more like those of the private sector. The Sovereigns have refused to balance their budgets, and have assumed huge liabilities from bailing out their banking systems. The lower levels for CDS reflects the progress made by municipalities in balancing their budgets.

CDS Rates	12/12/2008	6/30/2012
St of California	455	190
Greece	241	10,667
Spain	104	526
Ireland	204	552
Portugal	99	786
Italy	176	484

Deleveraging
The chart below shows the changes in borrowing by different sectors since 2006. Large amounts of debt were accumulated by all sectors into the first half of 2008. Since then Households, the Domestic Financial sector, and State and Local Governments have been paying down debt. The business



sector appears to be in pretty good shape, and has resumed borrowing at low levels since 2010. The Federal Government has been borrowing at a very rapid rate. We believe that this cannot continue much longer. This is occurring as we approach the "fiscal cliff" at the end of this year. This is when the Bush tax cuts are set to expire, and automatic budget cuts go into effect. We expect the Federal Government to become a headwind for the economy. The only way to bring the budget under control is to reduce spending, or increase taxes. Austerity is never a popular policy, but as many municipalities know, it is the only one that will work when there is too much debt and the budget is out of control.

The Economy
Global growth is slowing which is not inflationary. One sign of the slowdown here in the U.S. is the decline in the Manufacturing index. The graph below shows ISM for Manufacturing in the U.S. is now at 49.7 and is at the lowest level for the last 3 years. Readings below 50 are consistent with slow growth or recession.

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