Review

High quality fixed income portfolios performed well last quarter. The advance was led by longer maturity U.S. Treasuries in a flight to quality rally, as investors worried about the situation in Europe and the economy weakened. This sector was up over twice as much as intermediate taxable bonds. Munis were up nicely, but were unable to match the returns found in the taxable markets. High yield performed poorly due to the rout in equities. The returns for a variety of indices are shown in the table above.

Muni Index	Duration	Return For September	Return For 3Q 2011
ML Municipal 3-7 Yr Index	4.08	-0.15%	1.94%
ML Municipal 12-22 Yr Index	10.05	1.47%	4.35%
Taxable Index	**Duration**	**Return For September**	**Return For 3Q 2011**
ML U.S. Corp & Govt 5-7 Yr A Rated and Above	5.39	0.02%	4.43%
ML U.S. Treasuries/Agencies 7-10 Yrs	7.46	1.68%	9.45%
ML U.S. High Yield BB-B Rated	4.57	-3.02%	-4.99%

Stress In Europe

The chart below is for the 1-Year Euro Basis Swap, and shows the degree of stress in the international funding markets. It shows the worst reading since the crisis period surrounding the collapse of Lehman Bros. in September 2008.

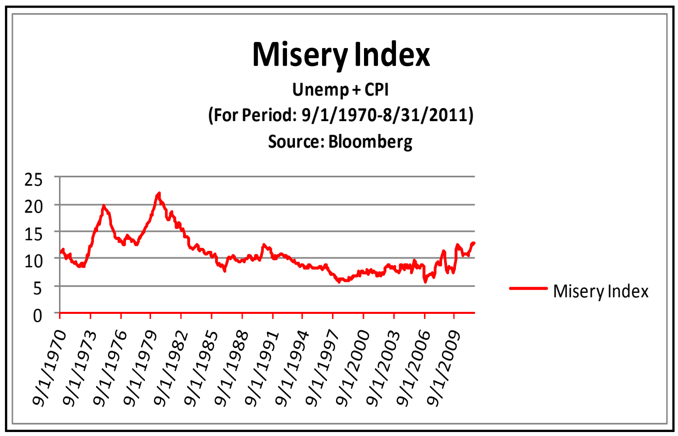
During the 2008 crisis the reading of the TED spread, which is a measure of stress in the U.S. funding markets, reached a low of less than -4.50. It is currently at –0.38 which is showing very little stress in our system compared to Europe. We will continue to monitor these measures for signs of improvement, or further deterioration. Credit is still readily available, but the cost has risen significantly for the peripheral countries in Europe. Continued weakness in the European banking system combined with austerity measures are creating a significant drag on the economy.

Japan and the U.S. Economy

We believe the primary problem facing the economy in the U.S. and other developed countries today is there is too much debt in the system combined with falling asset prices. There is no quick fix for this problem, and it will likely take years before we are finished with the deleveraging process. Japan has been going through this process now for over 20 years. The Japanese government has done all of the same things we are now doing: asset purchases, expansion of excess reserves, and a low interest rate policy. These policies have led to two lost decades. They have had a series of rolling cyclical periods of lackluster growth followed by economic weakness. Our base case scenario is for a similar situation here in the U.S.

The Fed

During the crisis in 2008 the Fed was successful in holding together the banking system and preventing a complete 1930's type of collapse. However, the policies which have been in place since then are powerless to get the economy going again. The Fed does not have the right tools to accomplish the job. Monetary policy and asset purchases are not creating jobs in an economy with too much debt. The chart above shows the Misery Index for the last 40 years. The index is the combination of the unemployment rate and the year over year CPI. Recent Fed policies have done little to lower unemployment, but have led to higher food and energy costs. This has led to a rise in the CPI to 3.6% during a period of time when inflationary expectations have been well anchored and home prices have been falling.



TEMPLETON
FINANCIAL SERVICES

Credit Comments
October 2011

Tax Law Uncertainty
Recently, the current administration recommended to the Congressional Super Committee certain changes in the tax code. We are most concerned about their recommendation to limit the deductibility of tax-free income for certain individuals in higher tax brackets. Under their proposal they would limit the benefit of municipal income for wealthy individuals. Their proposal would also make the continuation of the tax exemption for municipals subject to annual Congressional action. This would be a negative for municipal issuers, and would raise the cost of financing for the State and Local sectors. Fortunately, we feel this proposal has little chance of passage in its current form.

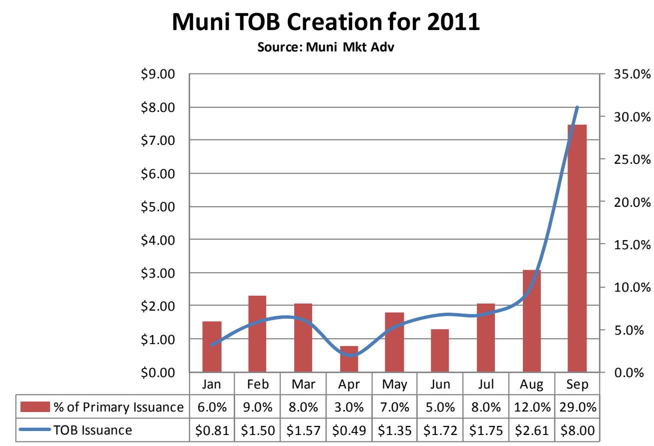
How About Job Creation?
During the crisis a couple of years ago the current administration chose to help lower the cost of municipal financing through the Build America Bond program. These bonds were taxable municipal securities for which the issuer received a subsidy from the Federal Government to help lower the cost of issuance. The proceeds were then used for projects to improve infrastructure needs, such as highway improvements and schools. These projects led to job creation and helped to stimulate the economy. The current plan is a complete 180 degree change for the Obama administration. By raising the cost of finance for municipal issuers this proposal would actually discourage job creation, and would lead to job destruction. This is not a good idea, because State and Local governments fund most of the infrastructure needs of our country. They build highways, schools, airports, prisons, office buildings, and help with subsidizing housing. In addition to discouraging job creation by raising the cost of financing construction projects, this also creates an enormous amount of tax uncertainty for investors. In short, this is an incredibly bad idea in this economic environment. We believe there will be little if any support for this proposal.

Muni vs Treasuries Ratios
During the recent rally in the bond markets U.S. Treasuries with longer maturities outperformed all other sectors. The table to the right shows the ratio of muni bond yields to UST yields for a variety of spots on the yield curve for AAA rated tax free bonds. Munis are currently cheaper than Treasuries for all maturities. The column to the right shows the average ratio over the last 20 years. We continue to find value in good A-rated safe sector bonds in both tax-free and taxable Munis. Safe sector bonds are general obligations (G.O.'s), essential service revenue bonds, and sales tax revenue bonds. We have been able to buy these types of bonds at spreads of over 100 bp's to the AAA Muni scale for tax frees. Taxable Munis are also trading at wider spreads than similarly rated riskier corporate bonds in the taxable markets. We feel these bonds will most likely outperform Treasuries in the future as spreads tighten.

Munis vs Treasuries For Different Parts of The Curve

Yrs To Maturity	Ratio %	Ave %
1	250	60
2	136	65
5	113	70
7	113	70
10	123	78
30	127	85

The Tax Free Yield Curve
The low interest rate policy of the Fed has caused yields in the short end of the market to remain at very low levels. This has led to investors moving out on the curve to pick up yield. This has caused the yield curve to "flatten". The spread between 2-30 years was as great as 434 bp's. It is now 321 bp's. We expect this trend to continue in the future. There has also been a positive development in the long end of the Muni market with the return of the Tender Option Bond (TOB) program. The table below shows the increase



in importance of the TOB during the month of September. These programs accounted for almost 30% of all purchases of new municipal issuance of long bonds last month. The return of these buyers creates more demand for long Muni bonds and will likely lead to a continuation of the flattening of the curve. This is good for accounts with barbell strategies in the long end of the market.

Conclusion
The weak economy, falling housing prices, and low level of inflationary expectations should continue to foster a favorable environment for high quality bonds.

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