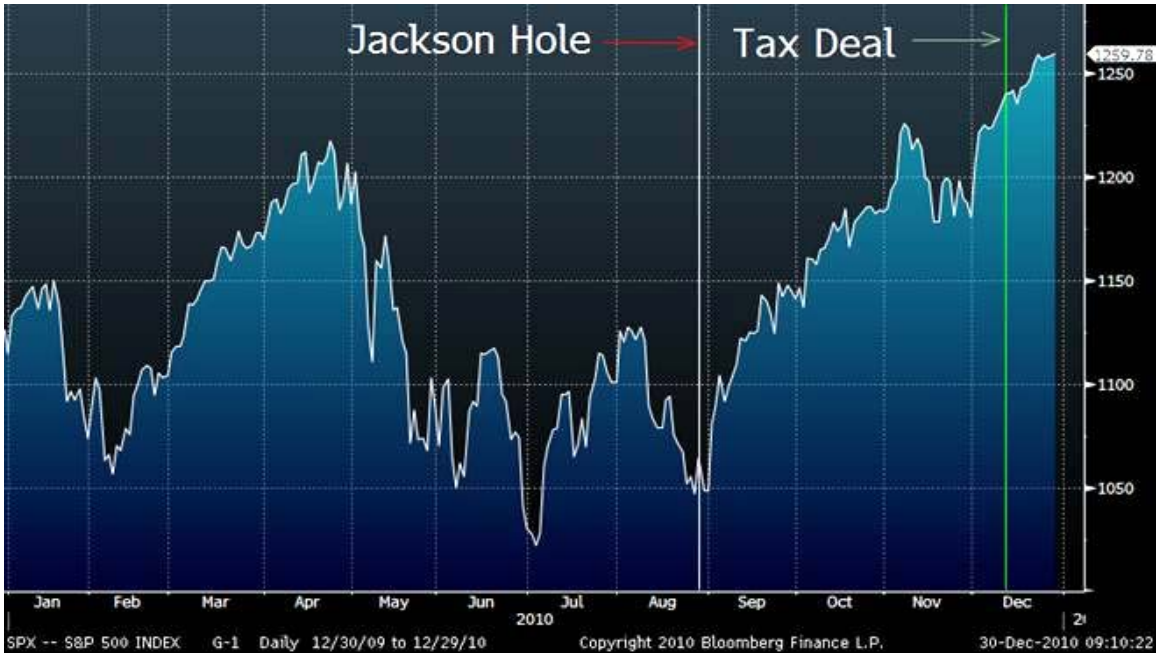
Fourth Quarter 2010 Commentary and Outlook

The municipal market had unquestionably one of the worst three-month periods in the last twenty years in the fourth quarter of 2010. A perfect storm (a hurricane actually – "category 5") knocked the municipal market on its back as the combination of higher U.S. Treasury rates, the unexpected expiration of the Build America Bond program, and persistent negative media stories on the fiscal health of municipal issuers undermined demand in a substantial way. Perhaps the most significant occurrence was the demise of the Build America Bond program which seemed to lose much of its sponsorship once the results of the mid-term congressional elections became clear. The country seemed to vote for higher levels of fiscal discipline, and a 35% subsidy by the Federal government to assist the states in borrowing was an immediate casualty of this perceived new mandate. When the reality of the December 31, 2010 expiration of the "BAB" program hit home with municipal issuers, the collective stampede to jump through the 35% subsidy window before it closed created a massive uptick in supply that easily overwhelmed demand. In fact, the final quarter of 2010 saw overall issuance levels exceed $130 billion which was the second heaviest quarterly issuance in municipal bond history. This gigantic amount of supply is both underappreciated and certainly underreported by the financial media who seemed to conclude in the aggregate that prices were falling due to investors concerns about credit quality – more on this later.

"Animal spirits" skyrocketed in the fourth quarter as investors embraced risk as the Federal Reserve Chairman's speech in Jackson Hole, Wyoming regarding buying U.S. Treasury bonds almost overnight eased concerns over a potential "double dip" recession. This combined with an unexpected compromise by President Obama with the Republicans on extending the Bush tax cuts rocketed equity prices higher (See chart below of the S&P 500 Index) and acted as a catalyst for



investors to take profits in their bond portfolios. While the U.S. economy is undoubtedly on firmer footing at the moment, it behooves us to warn investors that what monetary and fiscal stimulus giveth, they will certainly taketh away once the inevitable withdrawal of this financial adrenaline is at hand. Given the trajectory of the S&P 500 index since the Jackson Hole speech by the Fed Chairman, it makes good investing sense to point out that medium quality general obligation municipal bonds as a result of the fourth quarter selloff are often available at yields at or above 5% between 10 and 15 years on the yield curve. This equates to a taxable adjusted yield in excess of 7.5% (not including any state taxes that might apply). Given that we may be deemed biased as managing tax-free bond portfolios is what we are paid to do, it is conceivable we may be blinded in our optimism given the significant challenges ahead for state and local budgets in 2011. The monopoly that state and local governments enjoy in their ability to raise existing and new forms of taxes continue to be underappreciated by many. Look no further than the housing market where prices in most areas of the country continue to edge down. The often hyperbolic media continues to harp on the premise that lower housing prices should equate to lower property tax revenues for municipalities, which in turn raises the specter of mass defaults. This is actually wrong! In fact, property taxes continue to edge higher in most areas of the Unites States as tight budgets give political cover to local governments to ask homeowners to share more of the burden. According to Case-Shiller Home Price Indices, residential property values are down 29.5% from August 2006, yet local property tax receipts are up 36% since then. Certainly there will be individuals who will win property tax concessions as they spend countless hours gathering data to justify a revaluation of the levy they pay. However, the vast majority of homeowners will continue to see property taxes biased higher in 2011, much to their dismay. Feel free to write me a quick note challenging this assumption at mpietronico@millertabak.com. I suspect my "inbox" will be rather light disputing this topic. It is worth repeating – tax-free yields in some cases now exceed 5% for municipalities that have the ability to raise taxes in some of the following areas:

1. Property taxes (they are amazingly pulling this off)
2. Phone bills (have you looked at the local taxes charged lately?)
3. Cable and Satellite TV subscriptions (do you remember when television was free?)
4. Hotel stays (sometimes it seems that hotels slip your bill under your door in the middle of the night out of shame)
5. Water usage and garbage collection (municipalities know they got you looking down the barrel of a gun here)

We are not entirely dismissive of the credit concerns discussed in the media. In fact, we see municipalities' pension obligations as a serious long-term issue that will require difficult decisions in the coming months and quarters for many political leaders. We suspect public employees, estimated to be as many as 1 in 6 employees in the United States, will feel the burden of working longer for less financial reward, as many in the private sector have experienced since the economy turned

down. In our view, comparisons of municipal credit quality concerns being similar to sovereign debt concerns currently affecting global bond markets seem particularly off base. According to a December 22, 2010 article in "The Bond Buyer" about "Rollover Risk" (this essentially was about the threat of losing market access for municipalities) a random sample of 2011 principal and interest payments due show the percentages of outstanding debt rolling over for the following countries and states:

Canada	43.42%
France	32.68%
Italy	45.62%
Spain	49.10%
California	3.14%
Illinois	2.94%
Minnesota	1.95%
Wisconsin	1.88%

Again, we are not minimizing the declining fiscal fortunes of some municipalities, but given that a great majority of the municipal borrowing over time is structured as "level" debt service each year, and that municipalities are legally required to have balanced budgets each year, it perhaps can be reasoned that massive default risks are overblown within the general obligation sector. With that said, it is (and always will be) our greatest mandate to protect your precious capital. We will continue to only invest in issuers we deem the safest by our ultra-conservative proprietary credit research.

Moving forward, it is clear that many challenges lie ahead for the tax-free bond market. We suspect that investors will remain concerned about clearing tax-free supply (the "training wheels" are off – Build America Bonds are gone) so price volatility should remain almost a daily occurrence especially further out the yield curve one ventures. However, given that the macroeconomic backdrop is significantly less positively biased without the massive government intervention currently at work, it seems prudent for us to tactically seek out opportunities to enhance the overall income level on your portfolios should the opportunity present itself to lock in generous yields. Investors like you who own municipal securities within a separately managed portfolio do not have to be concerned about forced selling like mutual fund investors do. Mutual funds may continue to see selling pressure and often that creates buying opportunities for those longer term investors like you. Our trading desk remains ready to scoop up any high quality issuers we deem as being "thrown overboard" at distressed levels.

Lastly, at the turn of each year it seems you often cannot get out of the way of many predictions from various "experts" on what the coming year might have in store for bonds, stocks,

commodities, housing, etc. We will spare you of yet another "top ten picks" list for 2011. What might make more sense from our perspective is to consider what seems to be priced into financial markets as we enter 2011.

1. Another good year for stocks in 2011.
2. Higher bond yields.
3. A greater threat of inflation rather than deflation.
4. Little threat of an unforeseen military conflict.
5. A slowly declining unemployment rate in America.

I mention some of these points only to note that how investors are "positioned" don't always carry a large degree of correlation to how investment returns largely "play out". I often repeat to myself at this time of year what one of my investing mentors early in my career often repeated to me: "The market does what hurts the most people". Look no further than the fourth quarter of 2010 in municipal bonds for validation of that premise.

The team at Miller Tabak Asset Management would like to wish you a healthy and happy new year!

Michael Pietronico

Chief Executive Officer