ASSET PRESERVATION ADVISORS

APA

SPECIAL MARKET REPORT

June 2013

Beginning with his remarks May 22nd before a Congressional committee and again on June 19th at a press conference following the Fed's regular meeting, Federal Reserve Chairmen Ben S. Bernanke has significantly rattled world equity and bond markets. This signaled to the market that the Fed's bond purchase program will taper off in the next 12-18 months and sent the markets into what *CNBC* called "The Taper Tantrum."

At the heart of investor concerns (or is it heartburn) is the timing of the interest rate increases. While the Fed confirmed that unemployment remains unacceptably high and inflation acceptably low, the Chairman confounded the markets with his somewhat confusing, and to some contradictory, remarks as to when the Fed would begin the process of "tapering" the purchase of mortgage bonds and thus allowing interest rates to rise.

Unfortunately, and reminiscent of EuroZone fears of summers past, the market appears to have overreacted to Bernanke's remarks and forced interest rates to spike with the benchmark 10-year treasury bond up 75 basis points in just a month.

Despite this fear driven market reaction, some fixed income investors see opportunity in the rapid rise in yields and, as we at APA are implementing, beginning to buy selectively and locking up what we believe are attractive yields in investment grade munis. More specifically, APA's views on this market overreaction include the following:

Extreme volatility in the market requires vigilance, patience and an eye on past-market moves in determining a course of action (which includes no action at all.) We believe the current market is simply an overreaction to Bernanke's comments and as such, mutual funds and ETF's are being forced to sell, prompting a "negative feedback loop." These actions have pushed municipal spreads as well as yields to levels that have not been seen since Meredith Whitney's comments in December 2010. Large mutual funds have also been forced to sell due to redemption pressures. These massive redemptions have led to an increase in the supply of bonds with little demand for bids in the secondary market. Many broker dealers that are designed to provide liquidity have either excess inventory or are being informed not to purchase any more bonds by their managers.

Active portfolio management and underlying credit analysis is key. We believe active management of bond portfolios should perform better in periods of market volatility through timely oversight of portfolio positions and active communication among advisors, traders, and credit analysts. In addition, APA performs detailed fundamental credit analysis on issuers and will only purchase those bonds from issuers that exhibit positive underlying credit strengths and not get caught up in "yield chasing."

Raising rates provides buying opportunities. APA believes municipals are essential in any well diversified portfolio and should be viewed as long term investments with tax-free income benefits. As such, we continue to advocate that the current market environment provides investors an opportunity to add high tax exempt yields to their portfolio. APA believes that the overreaction and temporary supply/demand imbalances in the market is a positive for investors who are looking to add to or build a muni portfolio with higher yields long term.

Remain Calm. APA highly recommends that our clients remain calm and not sell their muni positions in this current market. The investor is likely to receive few bids for items and the bids that will be received are likely to be extremely cheap. If an investor is in need of cash, we recommend they sell those bonds in the 1 to 3 year maturity range.

APA continues to emphasize a barbell portfolio structure in the current rate environment. Keeping in mind our expectation that rates will continue at current levels near term, APA continues to utilize and recommend a barbell structure for clients. In such a portfolio, bonds are held in short term (1-4 years) and long term maturities (10-15 years). The bonds with short maturities allow the portfolios to have a steady flow of maturing positions to take advantage of higher rates.

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