

The Year in Review

As part of our 2010 forecasts and as documented in our 2010 market outlook, we had anticipated significant volatility in the S&P 500 and indicated that we would look to manage equity exposure judiciously as conditions dictate. We also indicated that we planned on achieving our performance goals for 2010 by creating an asset allocation that we believe was minimally correlated to the success of the S&P 500.

One of the more widely used measures of volatility is the Chicago Board of Options Exchange (CBOE) Market Volatility Index. Commonly referred to as the VIX, it represents the implied volatility of the S&P 500. If you just look at the value at the beginning of 2010 (21.68) versus the value in late December (18.26) you would think that volatility went down during 2010. However the actual trend was not anything close to a straight line decline. From the opening of 21.68, the VIX declined to as low as 15.23 in April before going ballistic and hitting the year's high in May at 48.20. From there, volatility did decline, but in a zigzag fashion.



Over the course of the year, the market at times behaved as if it were judged certain developments relevant one day and then were dismissed another day as irrelevant because of something new, only to return to relevance at a later date.

2010

First Quarter

It didn't take long for the market to give us a dose of what we had in store. After hitting a 15 month high in early January, the market had an abrupt selloff. The market apparently took its cue from China's attempt to curb lending in order to rein in what most consider being an overheating economy. At the same time, the Obama administration was proposing to limit the risks banks could assume (perceived as reducing lending by now risk-averse banks) and rumors started to surface that the Senate lacked the votes to confirm Mr. Bernanke and Federal Reserve Chairman.

In a few short weeks, such concerns were deemed passé as Q4 2009 earnings beat expectations and the Federal Reserve raised the interest rate it charged banks for emergency loans from 0.5% to 0.75%. The markets took this as a sign that the economy was healing and that things were getting better. As a result, the VIX dropped to its year low of 15.23.

In April, the markets once again hit a rough patch and volatility spiked up and the markets declined. Generally, when volatility goes up markets go down and vice-versa. In a relatively short period of time, the markets were hit with the news that the Greeks had been spending more than they had been collecting in taxes. This resulted in an aid package from other Euro zone countries that contained austerity measures that the markets seemed to think the Greek government would not be able to implement. While this particular issue seemed to reside, it did periodically re-appear in the year's latter months, seemingly on a regular basis. The other events in April were the news that Goldman Sachs had created a portfolio of securities for a client that wanted to bet that the portfolio would go down. It also seemed that Goldman took bets from people that thought the portfolio would go up and also recommended the purchase of the portfolio to its other clients. Finally we had the Deepwater Horizon incident involving BP and the Gulf of Mexico oil spill.

2010

Second Quarter

For much of the summer, the markets were focused on the concern that the sovereign debt crisis that hit Greece earlier in the year was going to spread to the other PIIGS (Portugal, Ireland, Italy, Greece, and Spain) and the ongoing BP oil spill fiasco did not help matters. While the VIX declined from its peak, it remained a relatively high 27.37.

2010

Third Quarter

After Labor Day, the markets started a sustained rally into November. The impetuses for this were good employment and manufacturing numbers, as well as good numbers from the housing market. While not reflecting a strong economy, the improvement in these numbers was enough for investors to remove the double dip recession scenario from the mix. As a result, analysts raised earnings estimates for the remainder of 2010 and for 2011 and the markets followed suit.

Things seemed to go well until November when the markets were hit with another trifecta (is it us, or do these things seem to happen in three's?) of a disappointing earnings report from Cisco Systems, fears of an economic slowdown in China and a sharp decline in municipal bonds.

Fourth Quarter

2010

As part of our 2010 market outlook, we had indicated that we would continue to recommend being very selective about choosing municipal bonds, favoring larger general obligation issues that have more resources to address budgetary pressures and those that offer greater liquidity. Additionally, we recommended maintaining broad diversification across geographies and sectors. The ongoing surveillance of credits is important, so investors can't simply "set it and forget it."

In the fourth quarter, these projections became reality and we received a sneak preview of the type of volatility in the municipal bond market we can expect to see in 2011. In November and December, prices of muni bonds declined by over 7%.

The cause for the decline was apparently the Republican electoral gains in the mid-term elections, where they took control of the US House of Representatives and increased their numbers in the US Senate. Much like the proverbial snowball that rolls down the hill, the concerns just got bigger and bigger. Since Republicans took control of the House of Representatives, the thinking was that there would be a reduced desire for additional fiscal stimulus. This directly impacted the muni bond market thru the Build America Bond (BAB) program.

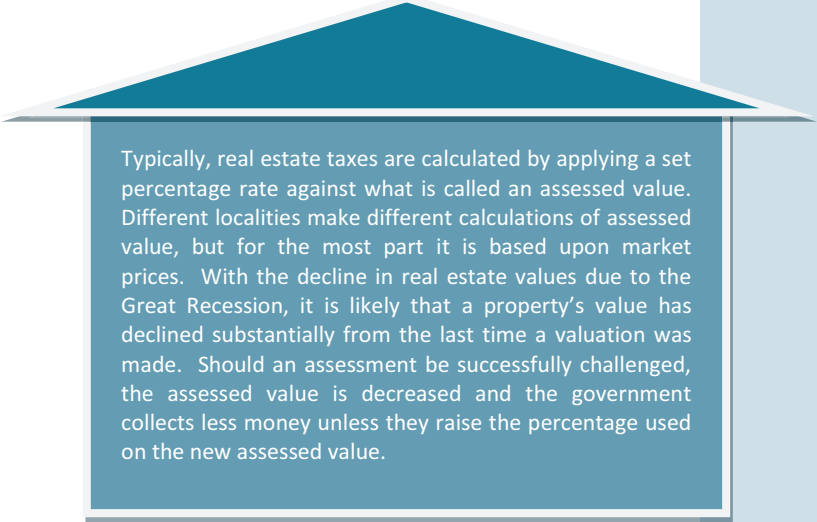
The Build America Bond (BAB) program provides a federal subsidy of up to 35% of the interest paid on bonds issued by municipalities. These are taxable bonds that can be sold to investors that would not normally buy tax-exempt issues as they are already tax exempt (i.e., pension funds). The BAB program is set to expire 12/31/10 unless renewed by Congress. At best, it was expected that the program would be renewed but with only a 28% subsidy.

Because the BAB subsidy was going to go away or be reduced, issuers rushed to get new issues to market before the program expires. Due to amount of bonds coming to market, issuers had to pay higher interest rates in order to sell their offerings. When interest rates go up, bond prices decline, so prices of existing bonds, both BAB and traditional tax-free, declined. This resulted in a decline in the value of bonds held by mutual funds as well. As investors saw the value of their muni bond funds decline, they submitted redemption requests, leading managers to sell some of

their holding and depressing muni bond prices further. From what we have observed, this sell off was not a credit quality issue, but simply a supply/demand issue. But that didn't stop the financial press from putting out stories about the financial condition of municipalities and their pension plans. Thus, we had a trifecta within the muni bond market: the midterm election, new issuance driving down prices, and the stoking of fears by the financial press. Because muni bonds reflect "stay rich" instead of "get rich" assets, fears of a muni bond market collapse sent the fear factor rising for equity markets as well.

In the last two months of the year, the financial press became to write frequently about many of the issues surrounding the municipal debt markets that we were discussing in last year's outlook, namely pension underfunding and increased borrowing to fund budget deficits. For 2011, these same issues will remain, but we are going to introduce another concern that likely won't get significant press coverage until later in the year. The new concern is that property owners will look to lower their real estate taxes by challenging their property value assessments.

Real estate taxes are mostly used to fund local government and schools. Most states impose an early spring deadline for filing tax grievances to lower assessments and the applications are adjudicated over the course of the remainder of the year. By early spring, we may start to hear about the record number of tax grievances being filed and the whispers may start about their impact on local government finances. The actual impact likely won't start before 2012, as successful tax grievances' are generally not retroactive, but apply to the following years taxes, meaning that the actual decline in real estate taxes may not start to appear until late 2012/early 2013 depending upon the local tax year.



Typically, real estate taxes are calculated by applying a set percentage rate against what is called an assessed value. Different localities make different calculations of assessed value, but for the most part it is based upon market prices. With the decline in real estate values due to the Great Recession, it is likely that a property's value has declined substantially from the last time a valuation was made. Should an assessment be successfully challenged, the assessed value is decreased and the government collects less money unless they raise the percentage used on the new assessed value.

As had been the case several times during the year, the turn of the calendar page caused a turn in market sentiment, this time from bearish to bullish as we entered the final month of the year. Wall Street strategists began to issue their corporate profit forecasts for 2011. Citing pent-up demand, plenty of cash, low interest rates and improved balance sheets, they see corporate profits increasing in 2011. This improved outlook drove the VIX down to 15.46 in mid-December, almost to the year low reached in April.

Summary

For 2011, we continue to expect there to be high volatility. As we explain in more detail in our 2011 forecast, some of the issues will continue to be China and its economic growth, the continuing saga of the sovereign debt crisis in the developed countries, and the ongoing condition of state and local financial health.