“We have met the enemy and he is us”
Walt Kelly, 1972, “The Pogo Papers”

Cartoonist Walt Kelly was a funny man. It also appears he had great foresight about our current financial crisis.

Most of our current financial pain is self inflicted both at macro and micro economic levels. There are a multitude of opinions as to why we find our economy in this spot at this point in time, but I will leave that macroeconomic discussion for another time. Suffice it to say, there is plenty of blame to go around and Mr. Kelly’s quip from 1972 isn’t too far off the mark.

Today, I want to focus on the micro economic implications of this crisis as it relates to bond portfolios and share with you some practical advice and offer answers to several questions that we have been asked often recently.

1. “Is my portfolio liquid?”

Simply put, true liquidity exists when an asset is readily convertible into cash. This requires a buyer in order to accomplish. Therefore, if you want liquidity, make sure your investment has attributes that appeal to many potential buyers.

At Bernardi Securities, Inc. we have always believed that complicated, leveraged, and opaque assets are less liquid. These features do not make for bad investments necessarily, only less liquid investments.

If we have learned anything over the past year, potential buyers dislike bidding on investments featuring these attributes: complicated structures, opaqueness, leverage and large investment positions.

As examples, this crisis has debunked the notion that auction rate securities are a liquid investment. Even owning shares in a large, name brand fund does not guarantee liquidity; remember the run on money market funds in September? Add leverage and a complicated structure to an investment’s attributes and you can almost guarantee illiquidity. In today’s world, there are many, many assets that share these attributes and these assets have a very limited market, if any, at this time.

This financial crisis has reinforced in our minds the significant advantage enjoyed by investors who use a SEPARATELY MANAGED, NON LEVERAGED bond portfolio strategy. This approach to bond investing lessens your volatility and increases your liquidity.

Investors who own quality, fixed rate, fixed maturity, non-leveraged bond portfolios have weathered this financial market meltdown better than most for a number of reasons. Among other things, separate account management allows for quality investments to be held when the market moves sharply downward. There are no forced sales in a separately managed bond portfolio unlike what often occurs in bond funds when bond prices plummet. When the general market recovers, so does the paper value of your investment. We have seen this time-tested phenomena proven correct again over the past month as interest rates fluctuated wildly. Additionally, if you need to raise capital you simply request bids for a portion of the bond portfolio;
even in this market, you will find bidders for smaller blocks of quality, shorter maturity, fixed rate bond issues. This simple strategy has worked well for decades and we expect that won’t change any time soon.

2. Should I own a derivative bond investment?

If you have read my previous musings over the years, you already know my feelings on this subject: Owning a derivative investment is not the same as owning a bond with a fixed rate and fixed maturity. It may have some of the same characteristics, but it is more complex and will behave differently in a volatile market. When markets plummet in value, it is highly probable that your derivative investment will lead the way downward and most likely will be very difficult to liquidate. If it is a leveraged derivative, the effects will be magnified.

Examine your investments so that you understand their true nature. The further removed your investment dollars are from the ultimate obligor(s), the more likely it is that you own a volatile, less liquid investment. For this reason, we avoided recommending auction rate securities (ARS) as a substitute for money market investments. We were never comfortable with the fact that the ultimate obligor, the municipal issuer, had in reality issued long term bonds and that it was only a third party (a securities firm or bank) that was promising to maintain the liquidity of the ARS investment. The investment was simply too far removed from the obligor for us to be comfortable with the notion that an ARS was a money market equivalent. It never was. The collapse of the ARS derivative market is a textbook example of how badly these markets can behave when there is great uncertainty and volatility.

If you’re not sure of the distance between your investment and the ultimate obligor, call us and we will try help you ascertain the answer.

3. Does my portfolio have solid credit quality?

We have long held there is no replacement for hands on credit analysis and believe strongly in the credit worthiness of traditional municipal issuer credits. These are two critical components to a sound bond portfolio management strategy.

Today’s poor national economy exerts additional stress on municipal budgets and, therefore, the need for thorough credit analysis is heightened. We need to remember that municipal finance is local, however. Municipal governments are ongoing concerns that have many tools in their collective tool kits to deal with this financial crisis: they can raise taxes, cut expenses and look for new revenue sources. It will not be easy, but if management responds quickly and appropriately most municipal issuers should avoid serious credit problems.

We believe conservatively run, non-leveraged municipalities are much better positioned to weather this financial crisis. Municipal governments that consistently produce balanced budgets without resorting to accounting gimmicks are much better positioned to weather this economic slowdown. Municipal governments that locked in affordable, fixed rate, fixed maturity bond issues to finance their long term capital projects are much better positioned to deal with these challenging times.

Municipal governments that have been living from paycheck to paycheck in recent years will find this environment very difficult. Municipal governments that have relied on long term financing to fund operating expenses will find this environment difficult. Municipal governments that have financed long-term capital projects with adjustable rate, short-term debt structures will find this environment difficult. And lastly, municipal governments that have become players in the financing business by entering into complicated, nearly incomprehensible (to this writer) credit default swaps, swaptions and other municipal derivative financings will find this environment difficult.

Understand the credits you own. Figure out what you own. What security stands behind your investment and how substantial is the security source? Can the security source be removed or diluted? What is the purpose of the issue? Was it a controversial project? Is it even necessary? Is the financing too complicated to understand? Ratings and insurance guarantees are only one credit metric to factor into your credit quality assessment. Thorough credit analysis is a complicated and time-consuming process; there are no short cuts.

A “trust, but verify” approach is essential to successful analysis and it often uncovers bond values along the way.

4. Where does the advantage lay in all of this volatility and is the end near?

I believe we are facing another six to twelve months of unease, continued uncertainty and volatility in the municipal bond market. These forces will ebb and flow during this period creating both continued anxiety and wonderful investment opportunities for the knowledgeable and the savvy.

As we stated in our February market update: “credit spreads will move back towards historic norms…this will create buying opportunities for the credit knowledgeable investor and a more attractive investor’s market than we have seen in a number of years.”

This certainly has been the case in the municipal bond market for the last several months.

Let’s examine the table below that charts various quality municipal bond yields over the last 2 years:

| Historical (Semi-Annual) MMD Benchmark Municipal Yields (as of 12/30/2006) |
|------------------|------------------|------------------|------------------|
| Rating Date      | AAA (2YR) | AA (2YR) | A (2YR) | Baa (2YR) |
| 12/30/06         | 3.52      | 3.67      | 3.64      | 3.80      |
| 06/30/07         | 3.76      | 3.83      | 3.90      | 4.06      |
| 12/30/07         | 3.97      | 3.02      | 3.20      | 3.54      |
| 06/30/08         | 2.63      | 2.72      | 3.13      | 3.84      |
| 10/30/08         | 2.55      | 2.62      | 3.19      | 3.99      |

Rows 1,3 and 5 focus on the basis points spread between the “AAA” and “Baa” rating categories for the various time periods.

As you can see, on 12/30/2006, investors received only 28 basis points more yield for investing in a 2 year, “Baa” rated issue versus the “AAA” rated, 2-year bond. Similarly, investors received 39 basis points more yield when buying a 10-year, “Baa” issue rather than a “AAA” rated credit.

Today, the picture is far different as the corresponding basis points spread comparisons are 144 and 156 basis points respectively. This represents a significant change reflecting investor’s understandable and well-placed concerns with credit quality.

It also makes for some wonderful investment opportunities.

Thank you for your continued confidence in our bond portfolio research and management process. As always, please let us know if we can help.

Sincerely,

Ronald P. Bernardi

President and CEO

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