PRESIDENT'S LETTER

BOND MARKET UPDATE
FEBRUARY 2008

THE BOND INSURANCE DEBACLE - "A FINE MESS"

- ACA Capital Holdings Inc., Standard and Poor's, "CCC" rating suspended, 1/11/2008
- AMBAC Assurance downgraded to "AA" by Fitch, 1/18/2008
- AMBAC Financial Group, Inc. reports $3.4 billion post tax fourth quarter loss tied to mark to market losses of credit derivatives portfolio, 1/22/08
- MBIA and AMBAC remain on Moody's and Standard and Poor's negative watch list, 1/23/08
- XL Capital Assurance (XLCA) rating downgraded from "AAA" to "A" by Fitch, 1/25/08
- FGIC downgraded to "AA" by Fitch and Standard and Poor's, 1/31/2008
- FGIC downgraded to "A3" by Moody's, February 2008
- One bit of good news: FSA and Radian Affirmed and Stable Aaa/AAA/AAA and Aa3/AA/A+ respectively

This is a fine mess, indeed, for the insurers of municipal bonds as the drumbeat of bad news grew louder this past month. We expect more bad news will follow as most of the municipal bond insurers are struggling to salvage their businesses crippled by the collapse in value of sub prime mortgages they insure. There is still great uncertainty as to the magnitude of mortgage losses that these companies face. Recent reports place the aggregate amount of new capital needed by these companies to retain their "AAA" ratings as low as $3.5 billion and as high as $15 billion. Understandably, an absolute crisis in confidence surrounds these insurers. **Ironically, the municipal bond issues they insure have not contributed to their problems**. Most of the insured bond issues are completely devoid of credit problems. Warren Buffet, recognizing the inherent soundness of the business of insuring municipal bonds, has entered the marketplace. At this point, the effect of all of this turmoil on the overall municipal bond market has been somewhat muted. This will change as the year proceeds.

Just as Oliver Hardy reproached partner Stan Laurel with his famous line, "…well, this is another fine mess you've gotten us into!", we too are left scratching our heads assessing the damage the monoline insurers have done to the municipal bond marketplace.

"*The curse of the insurance business, as well as one of the benefits, is that people hand you a lot of money for writing out a little piece of paper, and what you put on that little piece of paper is enormously important. But, the money that's coming in that seems so easy can tempt you into doing very, very foolish things. If you are willing to do dumb things in insurance, the world will find you…you'll see a lot of cash. And you won't see any losses. And you'll keep doing it because you won't see any losses for a little while. So you'll keep taking on more and more of it. And then the roof will fall in*".

Warren Buffet, 2003 Berkshire Hathaway Annual Meeting

And this is the exact scenario now playing out for many of the monoline bond insurance companies.

AMBAC was the first monoline bond insurance company and opened for business in 1971. MBIA followed three years later.

The industry grew slowly initially. By the latter part of the 1990s more than 50% of new issuance municipal bond volume was insured.

By 2007, there were seven "AAA" rated bond insurers that insured almost $2.5 trillion of various debt issues. In 2006, these companies insured approximately $574 billion of public sector debt and asset backed securities. This was approximately 6% above 2005 levels. Record revenues and net income of approximately $4.2 billion (a 9% increase from 2005) and $2.25 billion (an 8% increase over 2005) were earned in 2006 in spite of narrowing credit spreads.

The business of insuring municipal bonds was profitable from the beginning. Of, course it was. Insuring municipal bonds secured by real estate tax payments, water and sewer bill collections or sales tax receipts is a license to print money, some would argue because municipal bonds rarely default. Nice juicy premiums coming in each and every year over the life of the bond issue with virtually no defaulted issues to cover. Even the devastation inflicted on the Southeast by Hurricane Katrina in 2005 barely dented these municipal bond insurance companies as only a handful of issuers called on outstanding insurance contracts to make bond principal and interest payments. Add in a growing stream of income earned by the insurance companies' investment portfolios and the net revenue numbers cited above become very real. For many years, the average profit margin for these insurers was far above the Standard and Poor's average.

It was a marvelous, nearly free ride for these companies.

The bond insurance companies began to look towards new markets in the latter part of the 1990's to continue their growth. Underwriting spreads on its traditional municipal bond issue business were narrowing as competition intensified.

Seduced by the juicy underwriting fees they could earn by insuring structured finance products and international debt issues, almost all of the insurers jumped into these emerging markets feet first, arms waving wildly. The growth of these companies was explosive during this period. As an example, by 2006 approximately 30% of MBIA's new business was insuring municipal bond issues. The balance of new business was in other areas. It is this shift of focus and the fact that these insurance companies abandoned their cautious credit analysis approach when approving these complicated loans that led to the mess that most of them find themselves in today.

> "*All too often in our day to day wanderings through the municipal bond marketplace, we are continuously surprised to find the general attitude among certain investors that all bonds are really the same and that certainly all "AAA" rated issues are equal. The belief that an insurance policy on a bond issue somehow creates a "municipal bond commodity" that should be valued uniformly much in the way that we value other commodities is wrong. Yet this belief pervades our marketplace and from our perspective creates outstanding opportunities for the knowledgeable investor and portfolio manager."*
> **"*To be or not to be "AAA" rated*" or "*A rose by any other name is but a …*",**
> **Bernardi Securities, Inc., Bond Market Commentary Fall of 2000**

The events of the past month surrounding the deteriorating financial condition of the monoline insurers of municipal bonds are disturbing, but not surprising. They are disappointing, but not catastrophic. It serves notice to the bond investing world a reality that we have preached for years:

Municipal bonds are not all the same quality. The notion that many investors have had that all municipal bonds are equally secure is at best, a silly one and at worst, a dangerous one.

The importance of hands on credit analysis is critical to achieving portfolio peace of mind; focus and reliance on traditional municipal issuer credits remains an important component of sound portfolio management.

Know and understand the credits you invest in beyond what the rating agencies and insurance companies are proclaiming. Factor their assessments into your decision making, but do not stop the analysis at this juncture. Nothing, absolutely nothing takes the place of hands on, good old-fashioned credit assessment. Studying and understanding audit and other financial documents related to the bond issuer is the requisite practice. It is a time consuming, unexciting and, often times, inefficient endeavor. It is not a perfect solution, but it is a thorough way to determine credit quality in our view.

The next page details an example of our internal summary issuer credit report for an issue that is ACA insured. This issue is a Bernardi approved credit. Until recently, this credit was “A” rated (by virtue of ACA Insurance) by Standard and Poor’s. In December 2007, Standard and Poor’s dropped the ACA rating 13 notches to “CCC”. S&P subsequently dropped rating ACA issues altogether and this issue is now non-rated. It has remained a Bernardi approved credit throughout these downgrades. The summary information contained in the document is gleaned from a variety of sources including: annual issuer audits, Bloomberg database, direct conversation with the issuer or its advisor, County records and official statement documents.

THIS UTILITY ONLY: Purpose		Finance construction, additions and renovations to the Medical Center.			Date of Issue: 10/16/1998
Number of Users	**Not applicable**	Population	**2006 Estimate 13,963**	Total Revenue Debt: SEE NOTE	$ 2,980,000
Debt Per User	**Not applicable**	Debt Per Capita	**$ 213**		
	Fiscal Years	**12/31/2006**		**12/31/2005**	
Gross Income:		$ 62,376,050		$ 59,116,203	
Operating Expenses:		$ 55,550,479		$ 52,730,281	
(Net of depreciation & interest exp.)					
Net Available for Debt Service:		$ 6,825,571		$ 6,385,922	
Debt Service Amount:		$ 481,368		$ 476,618	
Debt Coverage:		**14.18 X**		**13.40 X**	
Net Available for General Obligation Bond Debt Service: SEE NOTE		$ 6,344,203		$ 5,909,304	
General Obligation Bond Debt Service: SEE NOTE		$ 1,755,258		$ 1,741,943	
Debt Coverage for All Debt Service		3.05 X		2.88 X	
Reserve Accounts as of:		12/31/2006		Bond Sinking and Reserve Fund:	$ 1,167,339
				Capital Improvement Fund:	$ 4,428,103
				Auxiliary Fund	$ 336,965
				Unrestricted Cash and Investments:	$ 11,836,630

Additional Information:

The Medical Facilities consists of a bed acute care hospital and a 128 bed skilled nursing home, plus primary care satellite clinics located in the Cities of. The Medical Facilities also rents medical office facilities to physicians and others under various lease agreements.

The bonds are special obligations of the City payable solely from gross revenues derived from the Med. Center . Gross revenues include patient and resident service and rental revenues (net of adjustments and uncollectible accounts), other operating revenues, non operating revenues (other than contributions restricted as to use so as not to be available for operating expenses or debt service), and a City tax levy as permitted by law. The City may, to the extent necessary and permitted by law, levy ad valorem taxes upon all taxable property in the City for the payment of expenses of administration, operation and maintenance of the Medical Facilities. The BONDS DO NOT CONSTITUTE A DEBT FOR WHICH THE FULL FAITH, CREDIT AND TAXING POWERS OF THE CITY ARE PLEDGED.

NOTE: Total Revenue Debt Outstanding does not include various General Obligation Bond issues outstanding in the amount of $16,975,000. These bond issues are secured by general obligations of the City for which its full faith, credit and taxing powers are pledged without limitation as to rate or amount, together with hospital net revenues of the Facilities. These five GO issues are insured by either MBIA or FSA and carry an underlying Moody Rating of A2.

1.25X Rate Covenant 1.25X Additional Bond Clause

As you can see, gross revenues are growing and are substantially greater (14 times in 2006) than required debt service requirements. Using a very conservative net revenue analysis, debt service requirements are covered approximately 3 times. Additionally, the City may (but is not legally obligated) levy ad valorem taxes upon all taxable property in the City for the payment of expenses of administration, operation and maintenance of the Medical facilities. This option further secures outstanding bonds, in our opinion.

This is an example of the type of credit analysis that we perform and, in our view, should occur independently of an insurance policy securing a bond issue. The fact of the matter is that over the past 5 - 10 years, this type of analysis was the exception rather than the norm in our industry.

The monoline insurers made detailed credit analysis superfluous in the minds of many people. The insurance was a marketing tool that allowed bonds to be sold more like a commodity rather than as the distinct credits that municipal bonds invariably represent.

Those easy days of credit assessment are gone for a while. This creates great opportunity for those who analyze bonds using a detailed methodology.

WHY BOTHER?

Here is a current market pricing comparison of three new issues recently brought to market.

All three issues were priced contemporaneously in December 2007. Here are details at the time of pricing:

Years	Issuer #1 UTGO Non rated Non insured Yield	Issuer #2 UTGO S&P "A" Non insured Yield	Issuer # 3 UTGO S&P "AAA" XLCA Insured Yield	MMD Scale "A" GO (12-27-2007) Yield
1/1/2010	3.80%	3.30%	3.26%	3.22%
1/1/2015	4.20%	3.80%	3.68%	3.82%
1/1/2020	4.60%	4.30%	4.05%	4.29%

(Priced as of the week 12/24/2007)

	Issuer #1 UTGO Non insured	Issuer #2 UTGO S&P "A" Non insured	Issuer #3 UTGO S&P "AAA" Insured
Assessed Valuation	$820,400,748	$1,462,250,394	$771,076,587
Direct Debt (less self supported debt)	$1,334,225	$41,750,000	$60,255,000
Direct Debt/ Capita	$73	$1,688	$736
Direct/ Overlapping Debt	$64,496,703 (7.86% of AV)	$223,714,857 (15.30% of AV)	$148,550,385 (19.3% of AV)
Total Debt/ Capita	$3,530	$9,045	$1,816
Population	18,273	24,734	81,823
Largest Tax Payer	4.40%	4.20%	1.51%
Top Ten Tax Payers	17.32%	16.60%	10.39%
General Fund Balance	($3,346,433)	$993,251	$2,080,820
Tax Collections	96.65%	99.62%	97.64%

Issue #1 is a Non Rated, non Insured General Obligation issue.

Issue #2 is an “A” Rated, non Insured General Obligation issue.

Issue #3 is a “AAA” Rated Insured General Obligation issue.

Compare the yield premium received by investors in Issue #1 and #2 to investors who were sold Issue #3. Investors in Issue #1 received 50 basis points more yield (½ of 1%) compared to similar maturity yields offered by issuer #3.

Investors in Issue #2 receive approximately 5 – 25 basis point more yield compared to similar maturity yields offered by Issuer #3.

Now, let’s compare some of the issuer’s underling credit attributes as shown on the bottom half of the information table. There are many similarities and some differences. Issue #1 has the lowest total debt and debt per capita numbers. It also has the lowest tax collection percentage and an operating deficit. Interestingly, upon deeper credit analysis one discovers that the operating deficit results primarily from expensing 100% of a significant capital project during the fiscal year rather than amortizing the cost over the useful life of the project.

All in all, the three credits when analyzed in detail are very similar independent of the insurance and investment ratings. And yet the yield-spread differentials as cited above, are fairly generous.

On January 28, 2008, approximately 30 days after Issue #3 was brought to market, Fitch Rating Agency downgraded XLCA from “AAA” to “A”. Moody’s followed shortly thereafter and lowered its rating of XLCA to “A3”.

Investors who bought the “AAA” rated Issue #3 in December now own a much lower rated issue with credit metrics very similar to issue #1 and #2 and at a much lower yield. Clearly, Issue #3 is not “AAA” quality and investors who bought it overpaid for it by accepting too low of a yield.

Investors in Issues #1 and #2 clearly bought better value than investors of Issue # 3.

Why bother with detailed, time consuming, unexciting credit analysis? Owners of Issue #1, now holding a 4.60% non taxable yield, know the answer to the question. I suspect owners of the initially overpriced, currently discounted, rating downgraded Issue # 3 also now know the answer to the question.

WHAT'S NEXT?

"*Everybody I knew was in the bond business so I supposed it could support one more...*"
Nick Carraway, The Great Gatsby

The above quote is a favorite of mine. It speaks to the resiliency of our market. It speaks to the opportunity it offers and the fundamentally important role it plays in our economic life.

The bond insurance industry will survive this calamity and the bond market will move forward as it always has done. The good news for the insurers is that approximately 50% of their portfolios rarely default (the municipal bond portion). But the market that lies ahead for the monoline insurers and many of their issuer clients will be difficult.

The value of bond insurance is now questioned by many and there remain great unknowns surrounding the monoline insurers and many of the issues they insure. This is troubling to say the least.

Here are some observations and practical advice that may prove helpful:

1. Always start with credit. Know and understand the underlying security you are buying and price it accordingly. We have tested this notion at Bernardi Securities. Inc. for decades and it works quite well. Cookie cutter credit analysis is a mistake (remember Issue # 3?). The notion that many bond investors have had that all insured municipal bonds are equally secure has proven false. If you have a portfolio replete with insured bond issues and you (or your advisor) do not understand the underlying security, you should be alarmed.

2. Credit spreads will move back towards historic norms (pre 2000), as bidders for bond issues will adjust their bids to reflect credit disparities, insurance aside. The days of the "municipal bond commodity" and corresponding "one yield fits all' pricing metric are over. 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. Many industry participants are ill equipped to make these credit distinctions presently, so market liquidity will become thinner at the margins, creating even greater opportunities. Insurance will continue to play an important role in our industry, but its dominance is lost for the foreseeable future as we anticipate an expansion of the bifurcated market that has already begun to develop.

3. Issuers will continue to look to insurance companies to insure their issues when it proves economically sensible. This will be the case less frequently in the near term as the era of easy money for many municipalities has ended. Borrowing costs for many will increase, leaving them with a difficult choice: delay the contemplated project or pass on the increased cost to the taxpayers or system users. Fortunately for the municipalities, current long-term interest rates are at low levels compared with the 1990s.

We will have to wait and see what the long-term ramifications are of this bond insurance debacle. In the meantime, like Nick Carraway, I think I'll stay in the bond business for a while longer.

As always, please call us with your questions or concerns. Thank you for your continued confidence in us and our bond portfolio research and management process.

Sincerely,
Ronald P. Bernardi
President and CEO
2/19/2008