

## HIGHLIGHTS

- 2011 defined by high volatility borne from unexpected, significant global macroeconomic events
- Several of the same factors that drove markets in 2011 are still present, poised to affect markets again in 2012. Remaining nimble will be key to navigating 2012's challenges
- Credit risk and interest rate risk will remain Caprin's dual focal points in investment policymaking in the coming year

## 2011 – A Year of Wild Cards

Last year was largely defined by “wild card” events that were difficult if not impossible to predict, and many proved to have a meaningful impact on market tone, direction, and momentum. Investment decisions were dictated largely by the “risk-on/risk-off trade,” with bursts of momentum that proved fragile and often short-lived. A few of last year's key events and their impacts were:

- The “Arab Spring” uprising: Higher fuel costs dampened early 2011 hopes for sustained economic momentum.
- The Japan earthquake: Aftershocks reverberated through second quarter GDP and the global supply chain.
- Europe concerns: Fear of spreading contagion from problems in Greece and Italy caused significant challenges for the Euro, which still suffers as a result.
- The D.C. debt ceiling debacle and the S&P Downgrade: The potential combination of higher taxes and reduced government spending inflamed concerns over their impact on economic growth. Notably, while S&P implied with its downgrade that US debt carried a higher risk profile, investors around the world asserted the exact opposite and flocked to US Treasuries, which clearly retain their role as the preferred “risk-off” vehicle.
- Operation Twist: The Federal Reserve found another tool to drive down longer-term interest rates and try to help inflate asset prices.

If we learned anything in 2011, it was to expect the unexpected. As we enter 2012, our focus remains on maintaining the liquidity essential to staying nimble as we adapt to what surely will be a rapidly evolving landscape.

## Municipal Bonds in 2011

Munis entered 2011 still reeling from high profile fear-mongering that grabbed so many headlines in late 2010. Retail investors fled the market fearing the predicted “50 to 100 sizable defaults totaling hundreds of billions of dollars.” Significant forced selling stemming from mutual fund outflows drove muni prices lower and yields higher.

Higher yields throughout the Muni market stemming from this forced selling presented a buying opportunity. Though state and local governments did face serious fiscal challenges, widespread systemic default was, by our assessment, highly unlikely. Beginning in January, we began to extend the maturities of portfolios by exiting low-yielding General Obligation, Pre-Refunded, and Water and Sewer bonds that matured generally within two years. We replaced these positions with higher yielding, longer maturities and sectors, including high quality hospitals and power authorities. The key to this rotation strategy was and continues to be Caprin's emphasis on credit quality. Striving to stay ahead of this evolving credit environment, we regularly review and assess the credit metrics and fundamentals of issuers.

This strategy paid off in 2011, as two key drivers pushed Municipal bonds towards becoming one of the strongest performing asset classes for the year: the worst case default scenario never unfolded, and new issue supply fell significantly from years past. There were defaults in 2011, but even some of the higher profile events were largely anticipated by the market. Harrisburg, PA and Jefferson County, AL had been on the brink of default well before the headlines of late 2010. The absence of widespread defaults reassured investors' confidence, leading them to once again seek tax free income without much fear of default. And with the lowest amount of supply since 2001, investors saw prices increase as demand far outstripped supply.

Caprin adapted to these supply constraints by more aggressively looking out of state for state-specific portfolios, understanding that the diversification and yield benefits from out-of-state opportunities often overcomes the trade-off from overlooking a bond's state tax-exempt status. This more open-minded approach allowed us to keep accounts invested with better bonds at the best available prices during a year significantly challenged by limited supply.

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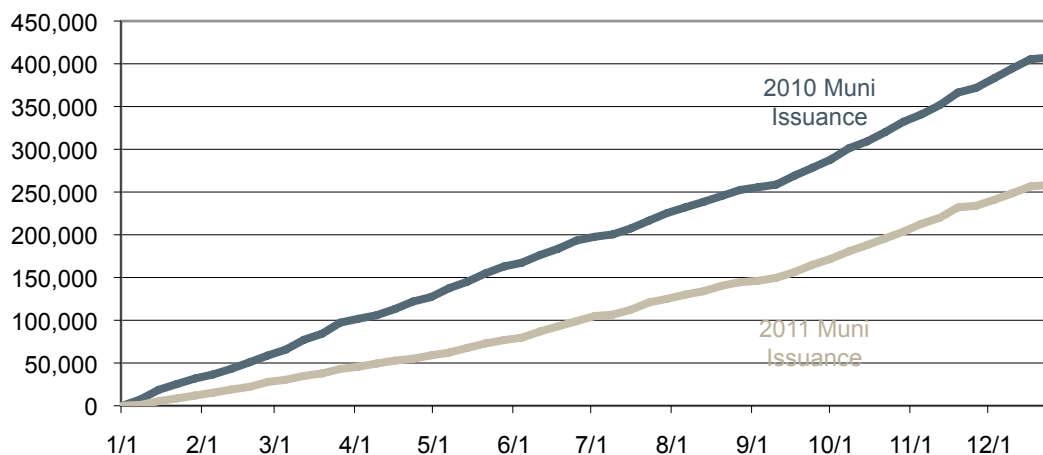


Figure 1. Total Municipal Bond Issuance – 2010 vs. 2011 (in millions) Source: Bloomberg

### Taxable Bonds in 2011

Fluctuations in the Taxable market also reflected the see-sawing “risk-on/risk-off” trade. The back-and-forth between corporate bond spreads and Treasury bond yields largely tracked volatility in the US equity market. Meanwhile, a persistently accommodative Federal Reserve, coupled with ongoing macroeconomic sluggishness, delivered an environment of overall lower interest rates, which supported strong fixed income returns throughout the year.

Caprin navigated this market with the same approach to prudent yield enhancements deployed in our municipal strategies. We sought to rotate out of lower yielding, short-maturity bonds and decreased our weightings in the US Agency sector while targeting more intermediate maturities in both corporate and taxable Municipals. Again, our credit focus remained paramount while we increased portfolios’ exposure to these sectors.

### Looking Ahead to 2012 – Key Drivers

#### Fed Policy

The Bernanke Fed has broken the mold for accommodation, and we expect aggressive policies to persist through 2012. The Fed has stated since its August 2011 declaration its intent to maintain exceptionally low interest rates through mid-2013. Recent whispers of further accommodation suggest the Fed is considering resuming purchases in the Mortgage bond market with the hopes of stabilizing and improving home values. Bernanke also plans to expand upon his efforts to further transparency by enacting formal disclosures of the Fed’s forecast for interest rates.

The rotation of four of the twelve Fed Policymaking Committee voting members deserves attention this year. Three of the four voting members stepping down this year were vocal critics of the Fed’s recent accommodative initiatives, even voting against the disclosure of a mid-2013 timetable for rates and the implementation of “Operation Twist.” Meanwhile, three of the four incoming members are viewed as dovish and more likely to go along with the Fed’s aggressive accommodation. This shift only enhances our view that the Fed will be targeting a continued low rate environment for the foreseeable future, so long as key economic metrics like housing and unemployment remain lethargic and inflation indicators remain muted.

Risks to this view include, first, stronger than expected economic activity and sustainable momentum that stokes inflation. Second, a supply shock, perhaps stemming from escalating tensions in the Middle East, could drive oil prices higher and potentially spread across other commodity prices. In this environment, we could see markets reset interest rates based on new metrics, and in effect lead, as markets have in the past, the Fed to revisit its interest rate strategy. Third, consumer confidence likely will play a critical role as well, and we will watch closely how consumers respond to what promises to be a year full of market moving events.

#### Europe

The resolution or exacerbation of Europe’s fiscal crisis will be a key contributor to market direction and momentum in 2012. Some positive signals began to emerge in late 2011 and early 2012 as leaders



seemed to grasp the extent and severity of the crisis. However, we remain skeptical that Eurozone legislative structures will overcome the nationalistic and political pressures that compete with the meaningful austerity measures and loss-sharing agreements required for stabilization. We expect whispers of a Eurozone break-up to get louder at points throughout the year, leaving us pessimistic for European market and economic prospects. For this reason Caprin has been avoiding Euro-dominated international ETF's within our Managed Taxable and Tactical Blend ETF strategies.

The risk to this outlook is that Europe surpasses admittedly low expectations and develops meaningful reform packages. With the Euro beaten up so badly through 2011, there is room for a correction if the largely priced-in negative outlook reaches a more positive resolution. Should this happen, it would impact our forecast and we would reevaluate our global outlook.

### 2012 Election

If the 2011 dysfunction in Washington is any indication, we expect the election season of 2012 to be downright nasty. Failure to compromise on meaningful long-term fiscal solutions to challenges facing the US led to the unprecedented 2011 debt downgrade. We expect the political environment to become even more toxic, holding out little hope for any kind of meaningful tax or entitlement reform this year. We will be closely watching how the ratings agencies respond to ongoing disappointments from policymakers, and we will also be weighing carefully how the markets respond to potential additional downgrades and any vulnerability of US Treasuries as the global investors' "flight to quality" vehicle.

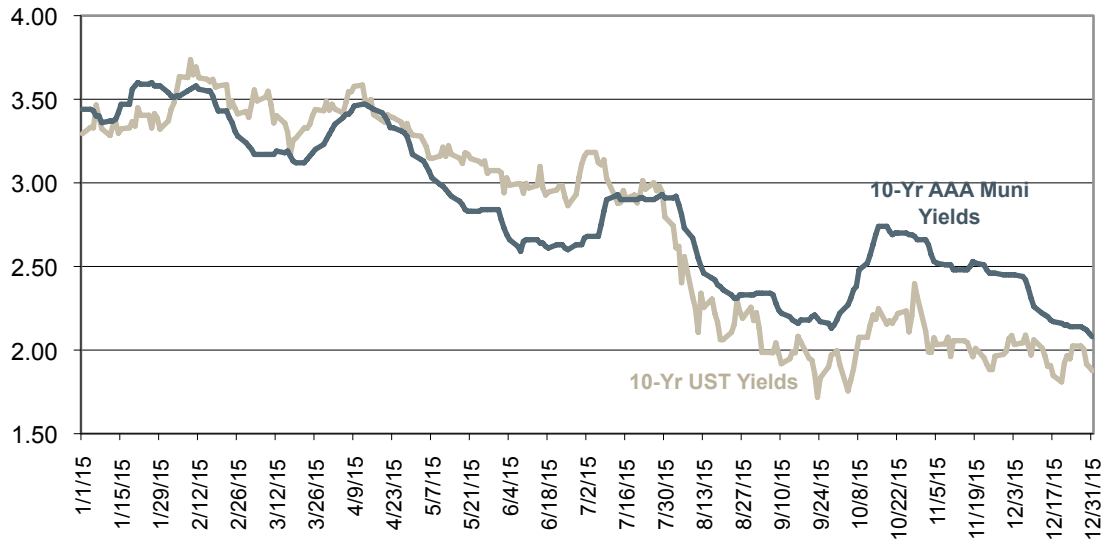


Figure 2. 2011 10-Year AAA Muni Yields vs. 10-Year U.S. Treasury Yields Source: Bloomberg

We will also be carefully monitoring the market implications of potential tax code changes and the treatment of Municipal bond income more specifically. Reform possibilities are bandied about from time to time, and rhetoric likely will escalate in 2012 while candidates jockey for support and policymakers seek additional sources of revenue. Though we believe any adjustments to the treatment of Municipal bond income would be short-sighted and disruptive to issuers struggling to support infrastructure needs, we don't believe this will stop such discussions from happening. Volatility across markets will fluctuate throughout the election season, with market direction and momentum ultimately dictated by the platform of the party that wins control of the White House and Congress.

### The Unexpected

Given all the unforeseen events that drove markets in 2011, we are mindful of another round of potential "wild cards" that could impact the markets this year. Possibilities include:

- An oil shock resulting from tensions in the Middle East
- The unexpected break-up of the Euro
- Further US debt downgrades driving investors to sell their Treasuries over longer-term risk concerns
- A Surprise QE4 out of a more dovish Federal Reserve
- The infamous, election year "October Surprise"



## Caprin Strategy and Positioning for 2012

### *Municipal Strategy*

Caprin continues to focus on and manage two key risk elements for Municipal bonds: Credit Risk and Interest Rate Risk.

- Credit risk – Revenue streams for state and local governments have by and large stabilized, and politicians have on the whole aggressively cut costs to achieve balanced budgets. However, as the US economy remains sluggish, state and local governments are not out of the woods. We expect another year of tough budget battles as elected officials continue to wrestle with challenging finances. It will be as important as ever for us to remain vigilant in monitoring and managing this risk for portfolios. The mantra for our decision-making remains in tact: “Know what you own.”
- Interest rate risk – We expect a benign rate environment to persist through 2012, but low absolute yields leave little margin for error. And, while we maintain duration targets consistent with each of our strategic mandates, we continue to manage extension risk out of Municipal bond portfolios.

Extension risk remains a significantly underappreciated risk in Municipal portfolios. A bond with a 30-year final maturity but a two-year call might look, trade, and behave like a two year bond in a low rate environment, and an investor might enjoy some extra yield for owning that bond while it remains priced to its call date. However, when interest rates rise, some callable bonds will not be called and will suddenly be treated and traded like a bond with a much longer maturity, 30-years in this case. In this scenario, the investor’s interest rate risk will have increased dramatically and will be reflected by meaningfully lower prices and greater price fluctuations.

While we realize near-term income is slightly reduced by avoiding this type of structure, Caprin believes it is appropriate to protect against the longer-term price risks posed by higher interest rates. To help offset the yield foregone by avoiding this structure, we will continue to seek opportunities prudently to rotate into states and sectors that offer incremental yield.

### *Taxable Strategy*

We will continue to monitor credit spreads closely throughout 2012 as we manage our increased allocation to corporate bonds. Within the finance sector, our focus is on high-quality issuers with maturities inside of five years to manage overall portfolio volatility. Within the utility sector, we favor those issuers best positioned to endure and thrive in an evolving regulatory environment. As of this writing, it does not appear the sector will be facing imminent cost and regulatory repercussions from the 2011 Japan earthquake, as was originally expected. While high quality industrial credits have performed well over the past several weeks, we are looking for trading opportunities to add names best positioned for the evolving economic outlook. We expect that taxable Municipal bonds will continue to comprise a meaningful allocation in portfolios as well. Caprin’s expertise in evaluating credit and trading of Municipal bonds helps us add yield over comparably rated corporate alternatives on a risk-adjusted basis and improve overall portfolio income.

### *Conclusion*

The markets fended off more than the occasional curve ball in 2011 – and 2012 is shaping up to see much of the same. Caprin managed risks and participated in opportunities through 2011 with prudent credit discipline and selective yield purchasing. We prioritize the management of risks as we traverse the volatility ahead, and we continue to value liquidity in our portfolios to remain nimble in what may well prove to be a rapidly evolving environment.

Caprin wishes to extend our heartfelt gratitude to clients and advisors we have partnered with, and we wish you a happy and prosperous 2012. We look forward to working with you in the years ahead.



CAPRIN

1802 Bayberry Court, Suite 202  
Richmond, Virginia 23226  
804] 648-3333

CAPRINBONDS.COM

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