KLS PROFESSIONAL ADVISORS GROUP, LLC
Complete Financial Management

PORTFOLIO CHANGES

Money Market Funds

As you are aware, we have had concerns with regard to credit quality and other issues in both tax-exempt and taxable money market funds, and, as a result, have invested short-term funds in Treasury-only money market funds. Recently, the federal government has injected capital into several major financial institutions and has anointed these institutions "too big to fail." The government has also undertaken to back-stop and support the commercial paper market by providing liquidity. Further, tax-exempt money market funds have reoriented their holdings and are primarily investing in directly issued variable rate demand notes (as opposed to synthetic VRDNs) and other direct obligations. The tax-exempt money market funds have also become more credit conscious with respect to the liquidity providers that stand ready to purchase the VRDNs. For the most part, the Funds are emphasizing the large institutions that have been supported by the U.S. and foreign governments.

These changes in the money markets and credit markets have alleviated our prior concerns and, for most clients, we are, effective today, shifting funds back to tax-exempt money market funds for personal non-tax deferred accounts and taxable commercial paper oriented money market funds for retirement accounts. This will result in a significant increase in the interest rates earned on these short-term funds.

Municipal Bonds

Since the onset of the credit crisis, the balance sheets of municipal bond insurers have come under significant financial pressure as a result of credit default swap insurance provided for mortgage-backed securities. As a result, the adequacy of the capital base of these insurers has been impaired and they have suffered significant downgrades in their credit worthiness.

We have always focused on the underlying credit of the issuer when investing in municipal bonds and have emphasized general obligation bonds and high quality revenue bonds. Nevertheless, we have invested in only those bonds that had additional credit enhancements—often insurance. As you are aware, our typical municipal bond portfolio has a short average maturity and is of high credit quality, apart from any insurance. We intend to continue to hold these securities. With regard to future direct purchases of municipal bonds, however, we have decided to purchase only those bonds that have been pre-refunded or escrowed to maturity with Treasury securities provided as collateral in each case. We desire, however, to continue to participate in the broader municipal securities market. In order to mitigate the credit risks that may materialize over a longer period as the economy works through recession and municipal tax revenues decline, we have determined that issuer diversification is of paramount importance.

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To this end, we will invest in the Vanguard Insured Long-Term Bond Fund, a high credit quality tax-exempt bond fund. It has an average maturity of approximately ten years and, due to the rapid decline in Treasury interest rates, is trading at a nominal yield (before adjusting for income tax benefit) that is significantly higher than Treasury bonds. We believe that over time, this yield differential will narrow or normalize. That is, prior to the credit crisis, municipal yields were 70-80% of comparable-term Treasury yields—now in excess of 100% and, at times, as much as 130%.

For many years we have advised clients that in a bond fund you cede control over maturity and credit quality to the bond fund manager and that we have, in the past, preferred investing directly in bonds that we could individually select. In this market environment, we believe that diversification as to issuers and geographic location necessarily trumps these concerns. Paying some state income tax (generated by the investments in bonds of states other than the state of residence of the investor) is the price of diversification and diversification compensates for the lack of confidence in the bond insurers.

Corporate Bonds

For many years we have observed that the 50-100 basis point yield advantage in investment grade corporate bonds was insufficient compensation for their additional inherent risks as compared to Treasury securities. As the credit crisis has unfolded and the market has repriced risk in all areas, investment grade corporate spreads have widened to 400-500 basis points over the comparable term Treasury. This means that such bonds have a yield-to-maturity of 7.75–8.75% in a static interest rate environment. We view this as an appropriate pricing of risk given the economic environment and believe there to be an opportunity to invest funds at an attractive current yield while still allowing for the possibility of a capital gain if corporate interest rates should decline as a result of the narrowing of credit spreads as the economy works through crisis to recession to recovery. We caution, however, that if credit spreads should widen or the interest rate environment should move upward, bonds will decline in value. As you are aware, corporate bonds are directionally correlated with equities. For example, in the period that stocks declined 22%, investment grade corporate bonds declined approximately 9%.

In an environment where corporate interest rates decline and bonds are appreciating in value, it is likely that equities will similarly be appreciating in value, and perhaps at a higher rate.

In order to execute an investment in corporate bonds and achieve the appropriate credit diversification, we must utilize a bond fund. We view an investment in the Loomis Sayles Investment Grade Bond Fund, with an average maturity of approximately 12 years, as an appropriate "equity substitute" as it has potential for capital appreciation while currently providing equity-like returns through yield to maturity in a static interest rate environment.

Execution

Because each KLS client account is managed individually, we will execute trades in accordance with the overall portfolio construction and individual client needs for liquidity. We also have constraints with respect to retirement plan funds where the investment selection is not an open platform.

This month there has been a great deal of volatility in the equity markets. At present, we continue to believe that the S&P 500 is trading at a high teens multiple relative to 2009 estimated GAAP earnings. While many focus on operating earnings which are projected by some to be more than double GAAP earnings, it is important to remember that there is no standardized definition of operating earnings and that the divergence of GAAP and operating earnings at a time when the economy is in a deepening recession should be met with healthy skepticism. We will continue to keep you apprised of our views and believe that the adjustments that we are making to client portfolios will optimize our risk/reward position.

Please call your KLS Managing Director or Director should you wish to discuss any of these issues in greater detail.

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