

# Managed Duration Investment Grade Municipal Fund Portfolio Manager Commentary

NYSE: MZF

Q2 2010

United States Gross Domestic Product ("GDP") for the first quarter of 2010 was downwardly revised to 2.7 percent growth from 3.0 percent. This was unexpected and, although the economy is expanding, GDP growth did not break the 3.0 percent threshold that is considered necessary by economists for significant job growth. The official unemployment rate fell to 9.5 percent in June from 9.7 percent in May, which was due mainly to the fact that many people have once again given up looking for work. It is estimated that job growth will more steadily pick up for the remainder of the year and accelerate in 2011, however the official unemployment rate will likely hover around 10 percent for some time as workers re-enter the labor market. Leading indicators for businesses for the months of May and June were not very promising. New orders for durable manufactured goods fell 1.1 percent in May. The decline was led by a drop in transportation equipment orders. Consumer indicators were largely either flat or in negative territory over the past two months. The Federal Open Market Committee ("FOMC") met toward the end of June and once again kept the fed funds target rate at between zero and 0.25 percent.

The recovery of the United States' economy may have softened as it copes with the fall-out effects from Europe's sovereign debt crisis. State tax revenues have declined in the past few years creating chronic budget deficits and leading to decreased financial flexibility and liquidity. The close of second quarter coincides with fiscal year end for many states which calls for a balanced and approved budget for the upcoming year. Despite an approximately 1 percent increase in state and local tax receipts during the first quarter of 2010, many states have been forced to enact drastic measures to balance their budgets. Funds that were provided under the American Recovery and Reinvestment Act are set to expire at the end of 2010 and states must find a way to plug this hole. Governor Christie of New Jersey passed a budget which cuts school aid by \$830 million and lays off 1,000 state workers. Illinois, which has been reluctant to raise tax rates, has resorted to one-time measures such as cash flow borrowing to rectify its budget. To combat substantial unfunded pension liabilities some states are debating raising the eligibility age for retirement benefits, increasing participant costs, reducing state contributions, and lowering cost

of living adjustments. However, rates are historically low which increases the appeal of issuing debt. With abundant negative headlines regarding municipal bankruptcies and pension funding challenges, we recognize that municipal bond risk is elevated, however, the sector continues to be relatively safe with a low incidence of default. Debt-service payments generally constitute a small portion of general fund revenues and are high in a state's priority of payments and expenditures.

The municipal bond market felt a bit sluggish during the second quarter of 2010 and lagged the flight to quality rally of the US treasury market. Long maturity tax-exempt yields approached four percent, a resistance point for retail investors, and there were few market participants willing to push rates lower. Primary market supply for the year is closing in on a robust \$200 billion, however tax-exempt supply is down approximately 20 percent versus one ago. Build-America-Bonds ("BABs") have accounted for approximately 28 percent of the year-to-date municipal bond issuance, thus lowering supply, and anchoring yields at historically low levels. Tax-exempt mutual fund inflows were positive during the quarter but have slowed versus the same period one year ago.

The Barclay's Municipal Bond Index<sup>1</sup> returned 2.03 percent in the second quarter, according to Barclay's Capital. The municipal yield curve (from 1-30 years) flattened during the period from 385 basis points to 372 basis points. The yield on 30-year AAA-GOs<sup>2</sup> decreased by 15 basis points during the period, while 10-yr yields decreased by 30 basis points. Tax-exempt bonds underperformed the flight to quality rally within US treasury market which pushed the ratio of 30-year tax-exempt yields to 30-year treasury yields from 88.3 percent at the start of the quarter up to 103.1 percent at quarter-end.

Investors shied away from risk towards the end of the quarter which caused some credit spreads to widen, with scattered returns for lower-rated credit. Returns data show that investors favored securities with intermediate maturities as long maturity yields approached record lows. According to Barclays Capital, single-A rated bonds underperformed the general index by 16 basis points and BBB rated bonds outperformed the index by 82 basis points. High-yield tax-exempt spreads compressed during

the quarter and the Barclay's municipal non-investment grade index<sup>3</sup> outperformed the investment grade index by 107 basis points in the second quarter.

Both Moody's and Fitch recalibrated their municipal bond ratings to a global ratings scale. This change does not reflect an improving credit picture but does place municipal bonds ratings on the same scale as other asset classes. The new ratings scales

take into consideration the probability of default along with the recovery rate given default for municipal issuers. Many municipal bond sectors were upgraded as a result of the recalibrations with GO bonds and essential service bonds being the largest beneficiaries.

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For illustrative purposes only. Performance data quoted represents past performance, which is no guarantee of future results, and current performance may be lower or higher than the figures shown.

The forecasts and opinions are those of Cutwater Asset Management as of June 30, 2010 and are subject to change at any time due to changes in market or economic conditions. The comments should not be construed as a recommendation of individual holdings or market sectors, but as an illustration of broader themes. Such forward-looking statements are subject to significant business, economic and competitive uncertainties and actual results could be materially different. There are no guarantees associated with any forecast.

There can be no assurance that any closed-end fund will achieve its investment objective(s). The value of any closed-end fund will fluctuate with the value of the underlying securities. Historically, closed-end funds often trade at a discount to their net asset value.

**Municipal Bonds Risk:** There are also specific risks associated with investing in municipal bonds, including but not limited to interest rate and credit risk. Interest rate risk is the risk that prices of Municipal Bonds generally increase when interest rates decline and decrease when interest rates increase. Prices of longer term securities generally change more in response to interest rate changes than prices of shorter term securities. Credit risk is the risk that the issuer will be unable to pay the interest or principal when due. The degree of credit risk depends on both the financial condition of the issuer and the terms of the obligation. The secondary market for municipal bonds is less liquid than many other securities markets, which may adversely affect the Fund's ability to sell its bonds at prices approximating those at which the Fund currently values them. The ability of municipal issuers to make timely payments of interest and principal may be diminished during general economic downturns. In addition, laws enacted in the future by Congress or state legislatures or referenda could extend the time for payment of principal and/or interest. In the event of bankruptcy of an issuer, the Fund could experience delays in collecting principal and interest

**Additional Leverage Risk:** Certain risks are associated with the leveraging of common stock. Both the net asset value and the market value of shares of common stock may be subject to higher volatility and a decline in value. The AMPS market continues to remain illiquid as auctions for nearly all AMPS continue to fail. A failed auction is not a default, nor does it require the redemption of a fund's auction-rate preferred shares. Provisions in the Fund's offering documents provide a mechanism to set a maximum rate in the event of a failed auction, and, thus, investors will continue to be entitled to receive payment for holding these AMPS.

<sup>1</sup> The Barclay's Municipal Bond Index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be rated investment-grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. The index is unmanaged and it is not possible to invest directly in an index.

<sup>2</sup> General Obligation Bond ("GO")- A municipal bond backed by the credit and "taxing power" of the issuers' jurisdiction rather than the revenue from a specific project.

<sup>3</sup> The Barclay's municipal non-investment grade index is a rules-based, market-value-weighted index engineered for the long-term tax-exempt bond market. To be included in the index, bonds must be non-rated or be rated non-investment grade (Ba1 or below) by at least two of the following ratings agencies: Moody's, S&P, Fitch. The index is unmanaged and it is not possible to invest directly in an index.

***Consider the investment objectives, risks, charges and ongoing expenses of any CEF carefully before investing. The prospectus contains this and other information about the CEF. Please read the prospectus carefully before investing. To obtain a prospectus, visit [www.guggenheimfunds.com](http://www.guggenheimfunds.com) or contact a securities representative or Guggenheim Funds Distributors, Inc. 2455 Corporate West Drive, Lisle, IL 60532, 800-345-7999.***