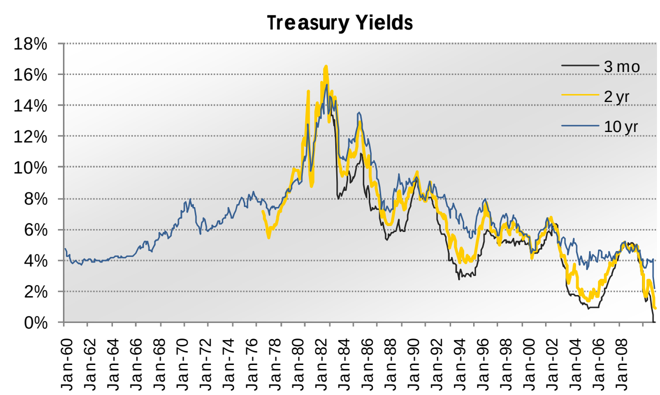
Newton's Third Law states, in simple terms, that for every action there is an equal and opposite reaction. The "action" we saw during 2008 was the unwinding of a massive bubble in housing, credit and leverage; the "reaction" to this unwinding has been a dramatic flight to safety, driving yields on Treasurys down to their lowest levels in decades. In December, investors were willing to accept a zero percent yield in exchange for liquidity and the full faith and credit of the federal government. Here we discuss the recent developments in the fixed income markets, and why we believe the next great opportunity lies in municipal bonds.

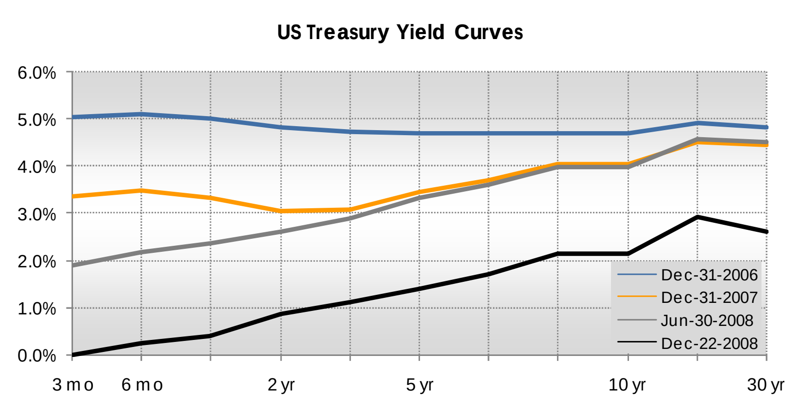
### *Inertia of Flight to Quality*

Sustained, easy conditions for money and credit earlier this decade helped draw the economy out of the 2001 recession, but as the pendulum swung to the other extreme it also fueled the housing and leverage mania that followed. We believe that the extreme risk aversion gripping the markets has set the stage for another reactionary bubble, but this time a bubble driving up the cost of safety.




*Source: U.S. Treasury Department*

On December 9th the government sold $30 billion of four-week Treasury bills at a rate of 0%, and $27 billion of three-month T-bills at a rate of 0.005%. The next day, yields on three-month bills briefly turned negative. This meant that in order to guarantee liquidity and safety, investors were willing to buy these securities for more than they would get back in principal at maturity, and with no interest payments. Record lows on 2-, 10-, and 30-year Treasury bond yields also were breached in December. The total return scenario appears even more dismal considering likely developments in the supply of Treasurys. As the tally grows on the government's economic bailout, we can expect a massive increase in the issuance of government debt to fund future outlays. The prospect of a supply glut has done little to suppress demand as the pursuit of safety and liquidity continues to outweigh concerns for return. Fears of a protracted economic slowdown also have supported demand on the short-end of the curve. Many investors have priced in deflation, so even with nominal yields at 0%, a negative inflation rate (deflation) would keep the expected real yield in positive territory. The Treasury yield curve has steepened and shifted downward dramatically over time to reflect both the flight to safety and dampened growth and inflation expectations.




*Source: U.S. Treasury Department*

*Acceleration of Credit Spreads*

The "flight to quality" into Treasurys has come at the expense of virtually all other sectors of the fixed income markets. As balance sheet deleveraging became a top priority, cash-strapped financial institutions were unable to provide the liquidity missing from the credit markets as individual investors fled into cash and Treasurys. Lack of liquidity caused markets to freeze, perhaps most famously the market in auction rate securities, which scared away investors whose primary concern was liquidity and safety. This resulted in a dramatic widening of credit spreads for most non-Treasury debt, well past a point that already seemed excessive months ago.

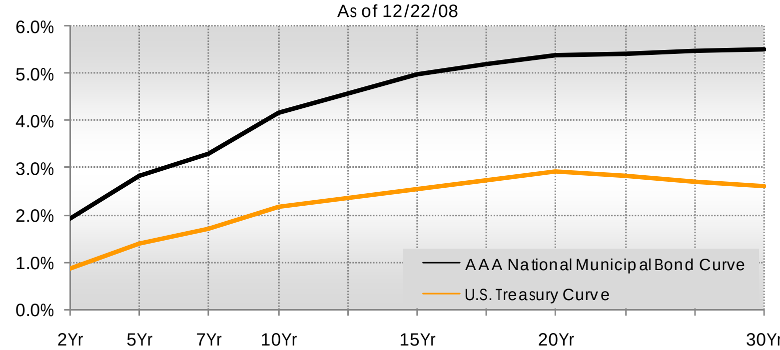
| Barclays Fixed Income Indices | | |
|---|---|---|
| As of 12/19/08 | Total Return Year to Date | Yield-to-Worst* |
| **U.S. Treasury** | **14.5%** | **1.5%** |
| Short Treasury | 2.9% | 0.2% |
| 1-3 Year | 6.6% | 0.6% |
| 3-7 Year | 13.8% | 1.2% |
| 7-10 Year | 19.0% | 2.1% |
| 10-20 Year | 21.7% | 2.9% |
| 20+ Year | 36.6% | 2.7% |
| **Municipal Bond** | **-4.0%** | **4.7%** |
| **U.S. Credit** | **-3.8%** | **7.0%** |
| **U.S. Corporate High Yield** | **-31.3%** | **22.0%** |

* Yield-to-worst is the lowest potential yield that can be received on a bond without the issuer actually defaulting.

The scenario we have here is one of extremes on opposite sides of the same coin: excessively low Treasury yields, and excessively high municipal and corporate yields. We believe this is a rather rare chance to capture some attractive returns from the fixed income market. Normally, we believe that the role of fixed income in a portfolio is to provide safety, diversification and income, not to be a significant source of total return. This year, however, investors in Treasurys have reaped all of these benefits as massive inflows pushed yields down and prices up to generate total returns of 3% at the short end of the curve and 20%+ at the longer end (as of 12/19/08). Room for additional price appreciation is extremely limited. In our view, the current environment provides another opportunity to reap gains in fixed income by going out a bit further on the risk curve to municipal bonds. We believe that investment grade munis are oversold and provide significant upside potential. Further widening of spreads is possible, but the income generation from yields at these levels is significant. The chart at the right shows the yield curves for Treasurys and AAA National Municipals: across the maturity spectrum, munis are yielding considerably more than Treasurys even *without* adjusting them upward for a taxable-equivalent yield. In fact, muni yields as a percentage of Treasury yields recently hit an all-time record. On a tax-free basis, the 10-year national muni shown here is yielding 4.2%, but making the adjustment the taxable-equivalent yield is 6.4%[1]. This compares quite favorably to a 2.2% yield on the 10-year Treasury.

**Municipal and Treasury Yield Curves**

As of 12/22/08




*Source: U.S. Treasury Department*

[1] Tax-free yield is adjusted to a tax-equivalent yield using the max 35% federal income tax rate: 4.2% / (1-.35) = 6.4%

### *The Relativity of Risk*

While there is a chance of default with any non-Treasury backed debt, we believe that the current risk/reward tradeoff for municipals is compelling:

- First, the historical record of losses from defaults by municipalities is very low, even during the Great Depression. Between 1929 and 1937, 1.7% of municipal debt was in default, however all but 0.5% of that defaulted debt eventually paid its obligations[2]. Unlike a corporation, a state or municipality does not cease to exist, which makes it more likely that it will eventually make good on its debt after a default. Otherwise, it risks being shut out of financing through the credit markets in the future.
- Second, we continue to believe that the recent pullback in municipal bond prices has been driven by factors not related to the underlying credit quality of the municipalities. The initial downturn in pricing came from a flight out of any risk-bearing assets, including municipal debt, to Treasurys. The lack of buyers in the municipal market created a liquidity-driven depreciation in the prices of these bonds. This downward pricing pressure was then compounded by the recent downgrades by rating agencies of the major municipal bond insurance companies (AMBAC, Assured Guaranty, MBIA, etc.). Much of the debt backed by these insurers was punished without discrimination, and currently little-to-no value is priced in for this insurance.
- Third, the liquidity situation should improve as individuals are drawn to the attractive taxable-equivalent yields. This trend should accelerate if tax rates increase, which we expect could happen early in the new administration.

### *Putting a Plan in Motion*

| **Fundamental Information on Select iShares ETFs** | iShares Barclays Short Treasury Bond ETF | iShares Barclays 7-10 Year Treasury Bond ETF | iShares S&P California MuniBond ETF | iShares S&P National Muni Bond ETF | iShares iBoxx $ Investment Grade Corporate Bond ETF | iShares S&P 500 Index ETF |
|---|---|---|---|---|---|---|
| Distribution Yield[1] | 1.51% | 3.83% | 4.19% | 4.05% | 5.80% | |
| 30-Day SEC Yield[2] | 0.41% | 2.78% | 4.19% | 4.13% | 6.95% | 3.17% |
| Avg. Yield to Maturity | 0.39% | 2.08% | 4.68% | 4.56% | 6.78% | |
| Tax Equiv. Distribution Yield[3] | 1.51% | 3.83% | 7.11% | 6.23% | 5.80% | |
| Tax Equiv. 30-Day SEC Yield[3] | 0.41% | 2.78% | 7.10% | 6.36% | 6.95% | 3.17% |
| Weighted Avg. Maturity | 0.33 yr | 8.39 yr | 13.40 yr | 12.72 yr | 12.39 yr | |
| Weighted Avg. Coupon | 4.47% | 4.75% | 4.95% | 5.02% | 6.01% | |
| Number of Holdings | 14 | 16 | 86 | 221 | 101 | 500 |

[1] The annual yield an investor would receive if the most recent fund distribution stayed the same going forward.

[2] A standard yield calculation developed by the Securities and Exchange Commission that allows for fairer comparisons among bond funds. It is based on the most recent 30-day period. This yield figure reflects the interest earned during the period after deducting the fund's expenses for the period.

[3] Tax Equivalent Yield = Tax Free Yield/(1 – Tax Rate). For the California Muni Bond Fund, a blended Federal and State tax rate of 41.045% is assumed, while for the National Muni Bond Fund the highest Federal income rate of 35% is assumed.

All data as of 12/17/08 except iShares S&P 500 Index fund 30-day SEC Yield as of 11/28/2008

In the table above, we compare the iShares Exchange Traded Funds (ETFs) that invest in California and National munis versus two Treasury ETFs, a corporate bond ETF and the S&P 500 index fund ETF. The table above highlights the yield differentials between these investment options. Even going out to an intermediate term Treasury fund (7-10 year), the current yield is only 2.78% while California and National munis are yielding 7.10% and

[2] George H. Hempel, *The Postwar Quality of State and Local Debt*, National Bureau of Economic Research, 1971

6.36%, respectively. These compare favorably even to an investment grade corporate bond fund yielding 6.95%, which we believe holds a higher risk of default. The S&P 500 index fund ETF is yielding close to its long term average with a yield of 3.17%. Certainly attractive for an equity index, but we do not feel it is compelling enough to outweigh the volatility still gripping the equity market.

We recommend that our clients allocate their fixed income assets to investment grade municipal bonds. We favor holding a diversified, national municipal bond ETF for all clients, and also recommend that state residents hold California munis to reap the additional tax-free income benefits. Although California's budget woes have been in the headlines recently, we have seen that the state still has access to funding. In October, California successfully floated a $5 billion issuance of revenue anticipation notes and was able to avoid a cash shortfall. The auction drew a record level of orders from individuals, topping $3.9 billion, after a direct pitch from Governor Schwarzenegger. Given that there remains some level of risk, however, we feel it is prudent to invest in California munis of high credit quality. Our principal investment vehicle for this asset class, the iShares S&P California Municipal Bond Fund, has an average S&P credit quality rating of "AA", with 95% of fund holdings rated "A" or better. The iShares National Municipal Bond Fund also has an average S&P credit quality rating of "AA", and 97.5% of fund holdings are rated "A" or better.

December 23, 2008

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