

View
from the

Bond Desk

July 2010

Managing Municipal Credit Risk

■ by **Josh Gonze**,
Portfolio Manager

The year 2010 has brought a barrage of negative press concerning municipal credit quality ratings. With heavy budget deficits in most states, we do perceive a higher degree of credit risk in the municipal market than in recent years. But as portfolio managers, we don't want to overreact to newspaper headlines or allow them to guide our strategy.

There is no doubt that public finance is facing its biggest fiscal challenge in decades, with an average projected budget gap for the 50 states at 20% for 2011. Certainly defaults will be more common over the next decade. But that does not mean that the entire \$3 trillion market is in crisis or that federal bailouts will be required for most bonds to pay off as scheduled.

It's noteworthy that, at the time of their defaults, Thornburg did not own any of the bonds frequently cited in news articles about municipal risk such as: Harrisburg, Pennsylvania; Vallejo, California; and Jefferson County, Alabama. And it's also worth mentioning that the defaulted Harrisburg bonds are wrapped in Aa3-rated insurance from Assured Guaranty, and that most Vallejo bonds are backed by enterprise funds and have not experienced payment interrup-

tions. News articles invariably fail to mention those facts.

Recent data on state tax revenue has been somewhat encouraging. Overall state tax revenue was up in the first quarter of 2010, based on data from the Nelson A. Rockefeller Institute of Government. The improvement showed up in all three major sources of state tax revenue: sales tax, personal income tax, and corporate income tax. Still, state tax collections are down about 12% in 2010 from their 2008 peak.

Local tax collections are generally higher in 2010. That's because local taxes are primarily property taxes, and property taxes are based on assessed values, which hadn't kept pace with market values when house prices were rising.

Budget deficits don't automatically translate into bond defaults. Nearly all public entities have reserve funds, have the ability to raise taxes, and can cut spending. Furthermore, there is a high priority for debt service, at or near the top of the payment waterfall owing to the state constitution or state laws.

Longer term, unfunded pension liabilities could be the single biggest public finance challenge. A recent study from the Pew Center estimates the unfunded pension liabilities for state pension funds at \$450 billion.

However, an unfunded pension liability will not, by itself, drive a default or insolvency. We note that states are beginning to take positive actions toward making plan assets sufficient to meet liabilities, such as lower benefit levels for new employees, raising the retirement age, and requiring higher employee contributions.

To the extent that California serves as a bellwether for the country, we note that California cash receipts for May were 10% above estimates, and in the first quarter of 2010, California's collec-

tions rose by \$3.2 billion, or 19.1%, year over year.

There are low and moderate debt burdens at most states and municipalities, with debt-to-state GDP in the range of 0% to 7%. Debt service is a small percent of the budget expenditures for all states, in the range of 0% to 13%.

Bankruptcy is not a legal option for states. Chapter 9 bankruptcy is available to most local governments, but can (and has) been rejected by the courts when they find the municipality has other options. ■

How We Mitigate Credit Risk

- We are taking measures to mitigate the risk of bond defaults. At the same time, we are staying nearly fully invested and we don't see a need to shift from municipal bonds into other assets classes as a defensive posture.
- We focus our purchasing toward bonds that carry a pledge of an enterprise revenue stream, such as utility revenue bonds. We have raised the bar when buying bonds backed by appropriations of a legislative body, sales tax, and general obligations.
- We generally avoid all bonds that depend on economic growth in a region of severe economic distress (e.g. the City of Detroit).
- We have a bias in favor of double-barrelled bonds that carry two separate sources of repayment.
- We insist on a wide margin for declines in debt service coverage to occur, without interfering with payment of principal and interest.
- We look to sell any bonds that we've identified as exposing our portfolios to unwise risk of failure to pay principal and interest.
- We favor bonds that are secured by a mortgage lien on property or other valuable assets.
- We pay close attention to swap exposure and avoid credits with significant risk of being forced to post collateral or unwind large out-the-money swap positions.
- We maintain broad diversification across sectors, issuers, and, in the national funds, geographic areas.

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Global Debt and its Ramifications

by Jason Brady, CFA
Portfolio Manager

We have shifted gears in the current financial environment, from being concerned about personal wealth and solvency (mortgage crisis) to worries about corporate credit (credit and banking crisis) to headlines about Greece, Spain, and others (sovereign crisis). Though risky asset values are higher today than they were a year ago, the fear that we have not yet “fixed” many of the problems that got us into this predicament lingers.

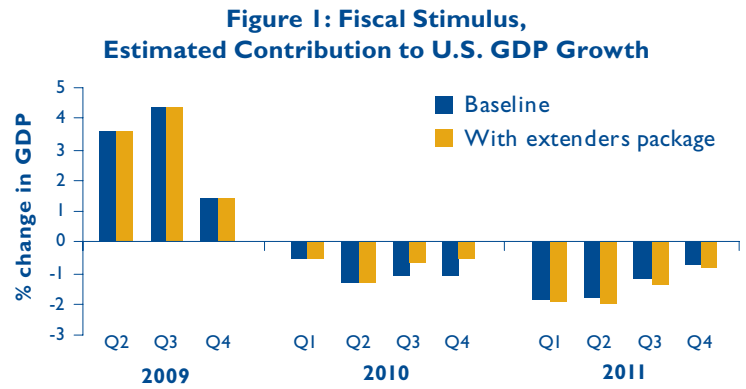
I think this fear is quite well placed. We have managed to identify many of the underlying issues behind the “Great Recession” of 2008-2009, but fixing those root causes is not simple. In short, we have too much debt. It is not a coincidence that the three crises I mentioned above correspond to the three largest sectors represented in global debt markets. In addition, during the past few years (or even, it could be argued, for the past decade) it has been debt markets that have driven equity markets: from the collapse of the homebuilders and the beginnings of the subprime contagion in 2007, to the dramatic failure of Lehman et al. due to funding problems in 2008, to the headlines and concerns about the ability of European sovereigns to roll over their maturing debt in 2009/2010.

The solutions thus far have been limited. Individual debtors have defaulted en masse, leading to “jingle mail” and “strategic default.” Corporations have by and large been spared due to low leverage, but banks (the locus and transmission mechanism for many of these problems) have had to suffer the indignities of TARP, significant additional regulation, and

massive deleveraging and globally are still working their way through poor balance sheets (witness the emphasis on European stress tests recently). Sovereign debtors have not yet discovered a way to both stimulate growth and to cut large spending deficits.

On the sovereign side, we seem to have arrived at this juncture mainly due to a desire to forestall significant economic contraction with large government spending. Going forward, I believe it is likely that these deficit spending countries (mostly in the developed world) will have to square their earlier gusto for Keynesian stimulus with an increasingly debt-phobic lending base and constituency. Yet the cuts in spending may prove far too painful in the short run. J.P. Morgan estimates that no additional stimulus spending in the United States is likely to lead to a growth drag of over 1% of GDP (see figure 1).

The adjustments that are currently being made to monthly non-farm payroll



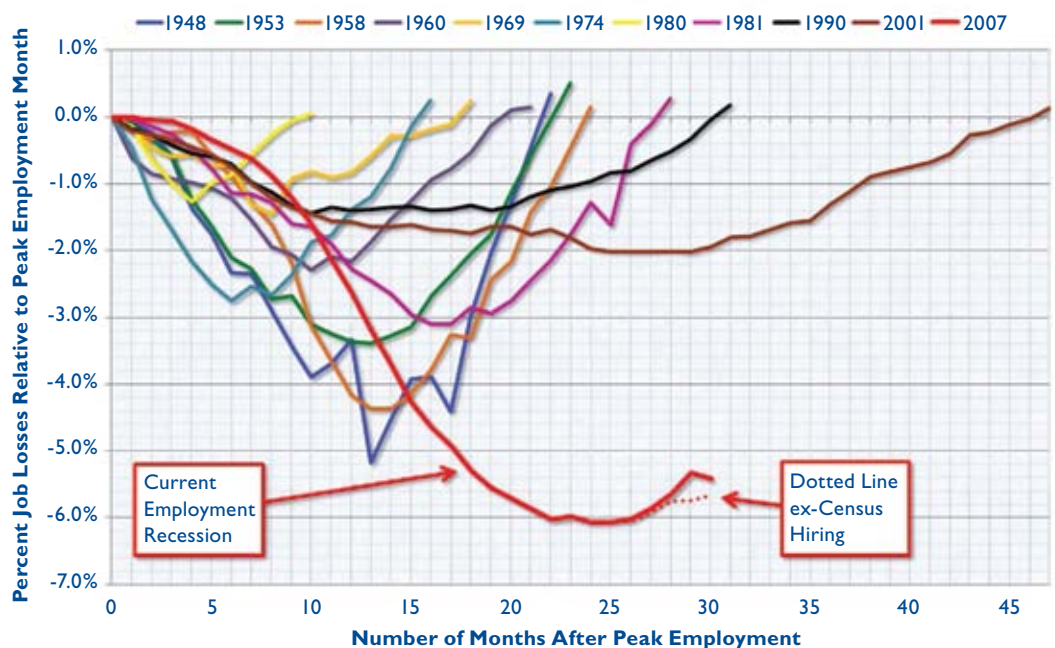
Source: J.P.Morgan, “Economic Research Global Data Watch,” June 25, 2010. Estimated contribution is the seasonally adjusted annual rate. The extenders package would extend tax measures such as research and development tax credit as well as unemployment benefits through the end of 2010.

numbers due to large contractions in census worker employment are emblematic of the government’s hand in stimulating the U.S. economy. It is more dire in other places; Ireland’s widely lauded cuts (lauded by the international lending community, mostly) have meant GDP contraction on the order of 20%. Greece’s public sector spending is currently supposed to be slashed, with many workers losing 16% of their pay (going from 14 months of pay to 12 months). It is no surprise that this has led to significant social unrest.

There is no easy way out of this position. In fact, the only plausible solution to me seems to be through currency devaluation. Ludwig von Mises, an Austrian economist (both by country of origin and by economic affiliation) wrote in his 1949 work *Human Action* that,

“There is no means of avoiding a final collapse of a boom brought about by credit expansion. The alternative is only whether the crisis should come sooner as a result of a voluntary abandonment of further credit expansion, or

Figure 2: Percent Job Losses in Post WWII Recessions, Number of Months to Recovery



Source: CalculatedRiskBlog.com

later as a final and total catastrophe of the currency system involved.”

While this language is somewhat extreme, the overall gist of von Mises’ thinking was that the stark choice between recession and devaluation was inevitable. With this sentiment in mind, I had to laugh at the *Financial Times* headline that held that the G20 meeting resolution was to cut deficits while stimulating growth. Furthermore, the earlier European solution to ongoing sovereign credit troubles was to make available up to \$1 trillion in further lending capacity. It is similar to the story of a monkey infestation in India. Rhesus monkeys had become so populous that they were blocking roads and even pulling IVs out of patients’ arms in order to get to the saline. The solution was to bring in larger, more aggressive monkeys. Larger monkeys don’t solve a monkey problem; more debt will not solve a debt problem.

For investors this puts the deflation/inflation debate front and center. If we in fact have austerity (Ireland) as opposed to further government leverage (Greece), then deflation will be the order of the day. This would involve drastic spending cuts, probably a double dip, and a fairly significant change in the financial outlook of the U.S. government, specifically. If, on the other hand, we don’t have the stomach for a gut wrenching recessionary period (and elected officials often don’t), the most likely outcome is significant further debt-fueled spending. Even in this scenario it is likely that over the medium term (say 2–3 years) we will remain in a low growth, low rate environment. I think, in the United States, it is difficult to overstate the importance of a 9.5% unemployment rate. At this point in the cycle, after a very difficult recession, a typical recovery would see a much faster decrease in unemployment (see figure 2) and a much larger increase in real GDP. In Spain, by comparison, the unemployment rate is over 20% and is therefore even less likely to be able to handle a dramatic spending cut.

In most countries, interest rates on government debt are currently low

Important Information

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit thornburg.com.

The Limited Term funds have a maximum sales charge of 1.50% for the A shares and a 0.50% contingent deferred sales charge (CDSC) on the C shares for the first year only. The Intermediate Term funds have a maximum sales charge of 2.00% for the A shares and a 0.60% CDSC on the C shares for the first year only. Strategic Income Fund has a maximum sales charge of 4.50% for class A shares and a 1.00% CDSC on C shares for the first year only. There is no up-front sales charge for class I shares. Class I shares may not be available to all investors and may have higher minimums.

Thornburg Investment Management and Thornburg Securities Corporation have contractually agreed to waive fees and reimburse expenses through at least February 1, 2011, so that actual expenses do not exceed the subsidized expense ratio.

Investments in the Funds carry risks, including possible loss of principal. Bond funds have the same interest rate, inflation and credit risks that are associated with the underlying bonds owned by a fund. The principal value of bond funds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. This effect is more pronounced for longer term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Funds invested in mortgage backed securities may bear additional risk. Investments in lower rated and unrated bonds may be more sensitive to default, downgrades, and market volatility; these investments may also be less liquid than higher rated bonds. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Investments in equity securities are subject to greater market fluctuations than bond securities. Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility. Investments in small capitalization companies may increase the risk of greater price fluctuations. Investments in the Funds are not FDIC insured, nor are they deposits or guaranteed by a bank or any other entity. There is no guarantee the funds will meet their stated objectives.

Performance as of June 30, 2010

	Average Annual Total Returns					Annual Operating Expense Ratios	
	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Incep.	Subsidized	Total
Limited Term Income Fund							
Class A Shares (THIFX Inception: 10/1/92)							
Without sales charge	11.96%	7.20%	5.26%	5.70%	5.72%		
With sales charge	10.25%	6.65%	4.95%	5.54%	5.62%	0.99%	1.04%
Class C Shares (THICX Inception: 9/1/94)							
Without sales charge	11.70%	6.94%	5.01%	5.39%	5.46%		
With sales charge	11.20%	6.94%	5.01%	5.39%	5.46%	1.24%	1.82%
Class I Shares (THIIX Inception: 7/5/96)							
	12.35%	7.56%	5.61%	6.03%	6.04%	—	0.68%
Limited Term U.S. Government Fund							
Class A Shares (LTUSX Inception: 11/16/87)							
Without sales charge	5.67%	6.55%	4.82%	5.25%	6.01%		
With sales charge	4.07%	6.03%	4.50%	5.09%	5.93%	—	0.94%
Class C Shares (LTUCX Inception: 9/1/94)							
Without sales charge	5.36%	6.26%	4.54%	4.94%	5.02%		
With sales charge	4.86%	6.26%	4.54%	4.94%	5.02%	1.24%	1.72%
Class I Shares (LTUIX Inception: 7/5/96)							
	5.99%	6.86%	5.13%	5.57%	5.61%	—	0.67%
Strategic Income Fund							
Class A Shares (TSIAX Inception: 12/19/07)							
Without sales charge	19.16%	-	-	-	6.86%		
With sales charge	13.82%	-	-	-	4.94%	1.25%	1.49%
Class C Shares (TSICX Inception: 12/19/07)							
Without sales charge	18.54%	-	-	-	6.26%		
With sales charge	17.54%	-	-	-	6.26%	1.80%	2.29%
Class I Shares (TSIIX Inception: 12/19/07)							
	19.57%	-	-	-	7.17%	0.99%	1.12%

Performance as of June 30, 2010

	Average Annual Total Returns					Annual Operating Expense Ratios	
	1 Yr	3 Yrs	5 Yrs	10 Yrs	Since Incep.	Subsidized	Total
Limited Term Municipal Fund							
Class A Shares (LTMFX Inception: 9/28/84)							
Without sales charge	6.99%	5.14%	3.88%	4.18%	5.58%		
With sales charge	5.36%	4.62%	3.57%	4.02%	5.52%	—	0.86%
Class C Shares (LTMCX Inception: 9/1/94)							
Without sales charge	6.62%	4.83%	3.58%	3.87%	3.87%		
With sales charge	6.12%	4.83%	3.58%	3.87%	3.87%	1.24%	1.63%
Class I Shares (LTMIX Inception: 7/5/96)							
	7.26%	5.46%	4.23%	4.53%	4.54%	—	0.53%
Intermediate Municipal Fund							
Class A Shares (THIMX Inception: 7/22/91)							
Without sales charge	9.27%	4.75%	3.77%	4.59%	5.25%		
With sales charge	7.07%	4.04%	3.36%	4.38%	5.13%	—	0.98%
Class C Shares (THMCX Inception: 9/1/94)							
Without sales charge	8.88%	4.46%	3.50%	4.26%	4.29%		
With sales charge	8.28%	4.46%	3.50%	4.26%	4.29%	1.24%	1.76%
Class I Shares (THMIX Inception: 7/5/96)							
	9.53%	5.08%	4.10%	4.92%	4.82%	—	0.68%
California Limited Term Municipal Fund							
Class A Shares (LTCAX Inception: 2/19/87)							
Without sales charge	7.56%	4.85%	3.79%	3.75%	4.80%		
With sales charge	5.96%	4.33%	3.47%	3.60%	4.73%	—	0.99%
Class C Shares (LTCCX Inception: 9/1/94)							
Without sales charge	7.27%	4.57%	3.52%	3.44%	3.69%		
With sales charge	6.75%	4.57%	3.52%	3.44%	3.69%	1.24%	1.76%
Class I Shares (LTCIX Inception: 4/1/97)							
	7.99%	5.23%	4.14%	4.11%	4.22%	—	0.65%
New York Intermediate Municipal Fund							
Class A Shares (THNYX Inception: 9/5/97)							
Without sales charge	6.17%	4.79%	3.68%	4.25%	4.25%		
With sales charge	4.05%	4.08%	3.25%	4.04%	4.08%	0.99%	1.07%
Class I Shares (TNYIX Inception: 2/1/10)							
	-	-	-	-	2.28%	0.67%	2.10%
New Mexico Intermediate Municipal Fund							
Class A Shares (THNMX Inception: 6/18/91)							
Without sales charge	7.34%	5.13%	3.90%	4.35%	5.00%		
With sales charge	5.17%	4.43%	3.48%	4.14%	4.89%	—	0.96%
Class D Shares (THNDX Inception: 6/1/99)							
Without sales charge	6.98%	4.82%	3.61%	4.07%	3.81%	1.24%	1.73%
Class I Shares (THNIX Inception: 2/1/07)							
	7.63%	5.46%	-	-	5.00%	—	0.62%
Strategic Municipal Income Fund							
Class A Shares (TSSAX Inception: 4/1/09)							
Without sales charge	15.80%	-	-	-	18.22%		
With sales charge	13.46%	-	-	-	16.34%	1.25%	2.92%
Class C Shares (TSSCX Inception: 4/1/09)							
Without sales charge	15.45%	-	-	-	17.94%		
With sales charge	14.85%	-	-	-	17.94%	1.55%	2.78%
Class I Shares (TSSIX Inception: 4/1/09)							
	16.09%	-	-	-	18.58%	0.99%	2.12%

Past performance does not guarantee future results.

Continued, Global Debt

enough that they provide little barrier to a policy of continued high government spending. It is possible that this spending will stimulate growth that is in excess of the additional interest on the debt. If not, then the debt load will increase to the point where servicing it becomes a significant drag on economic growth (a dangerous feedback loop). Rogoff and Reinhart in their excellent book on sovereign debt, *This Time is Different*, estimate that the level of debt/GDP that begins to affect economic output in a country is 90%. Current estimates by the Congressional Budget Office show that the United States will hit this level before 2020. Other estimates put the date notably sooner. This is from a starting point of 40% debt/GDP in 2008.

With this level of debt, creating inflation in order to make debt service more palatable could become a significant priority for governments everywhere. Competitive devaluation would be in the air and the race towards real assets (gold, art, and ironically, real estate) could be monumental. As in the late 1970s, the focus for investors would be on “asset preservation” versus “asset growth.” I still do not expect this extreme outcome, but it is undoubtedly the case that we will be faced at some point in the next several years with a dramatic change in the outlook for long term rates (currently that outlook is for muted changes for a very long time). This will upset many fixed income investors and I fear will cause an ill-advised, wholesale move out of the asset class just as the horse has left the barn.

A corollary to the debt deflation/inflation dilemma is the marked increase in volatility over the course of the past several years. The VIX, corporate bond spreads, and events like the “flash crash” all indicate that we are in an environment of greater uncertainty. My belief is that the larger global debt load is partly to blame for this as well. The global situation is similar to the scenario where an individual has borrowed too much and faces various slings and arrows of outrageous fortune. If an individual’s leverage is high and they lose their job, or get a pay cut, or have a medical issue or anything

goes slightly wrong, that individual is more susceptible to having financial troubles. Globally, high debt makes us more vulnerable to all kinds of different shocks. I would expect that until we are able to work off high debt levels either through growth, inflation, or default, financial volatility will continue to be high.

In general, high debt levels in this country and globally will continue to drive investment outcomes for many years to come. ■

Glossary

Bond Insurance – Individual bonds are sometimes insured by private companies. The insurance guarantees the payment of principal and interest on a bond issue if the issuer defaults. In 2007 and 2008, the credit ratings of many bond insurers were downgraded, reflecting a decrease in claims paying ability of the insurers. Bond mutual funds are not insured, even if the underlying bonds are insured.

Basis Point – A unit equal to 1/100th of 1%. 1% = 100 basis points (bps).

Bond Spreads – The difference between the yields of two bonds with differing credit ratings. Most often, a corporate bond with a certain amount of risk is compared to a standard risk-free Treasury Bond. The bond spread will show the additional yield that could be earned from a bond which has a higher risk.

Credit Quality Ratings – A bond credit rating assesses the financial ability of a debt issuer to make timely payments of principal and interest. Ratings from the highest of AAA (or Aaa), AA (Aa), A, and BBB (Baa) are investment-grade quality. Ratings of BB (Ba), B, CCC (Caa), CC (Ca), C and D (the lowest) are considered below investment grade, speculative grade, or junk bonds. Unless otherwise noted, the ratings listed are from Municipal Market Data or Bloomberg Market Data (for corporate bonds) and are a combination of ratings from Standard and Poor's, Moody's Investors Service, and Fitch Ratings.

Distribution Yield – Yield calculated by taking the sum of the month's total distribution factors and dividing this sum by a 30-day period and annualizing to a 360-day year. The value is then divided by the ending maximum offering price per share to arrive at the annualized distribution yield. The yield is calculated on a periodic basis and is subject to change.

Enterprise Funds – In public finance, when city or county owns a self-supporting enterprise such as a utility or parking garage, for accounting purposes that enterprise is separated as an enterprise fund.

General Obligation (GO) – A municipal bond backed by the credit and "taxing power" of the issuing jurisdiction rather than the revenue from a given project.

Interest Rate Swaps – A contract between two parties to pay interest to each other for a specific time period such as five or ten years. Typically one party pays a fixed interest rate and the other party pays a floating interest rate. There is no swap of principal.

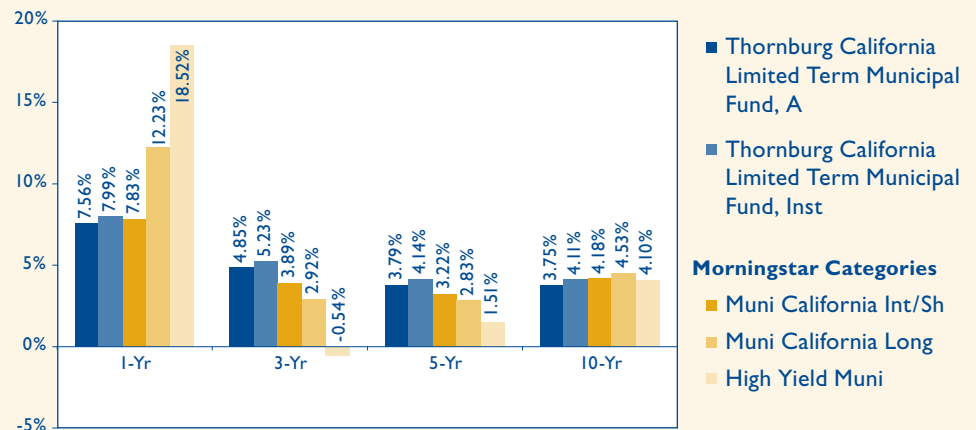
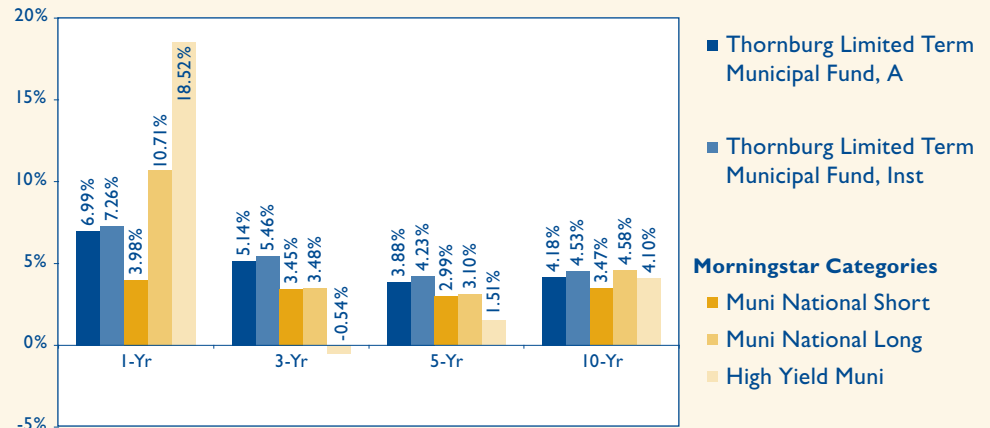
Out-of-the-money Swap – If interest rates have changed unfavorably for one swap counterparty, that counterparty may elect to pay a termination fee to terminate the swap. Thus the swap would be out-of-the-money for the paying counterparty, and in the money for the receiving counterparty.

VIX – The ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500 index options. This volatility is meant to be forward looking and is calculated from both calls and puts.

SEC Yield – Yield computed in accordance with SEC standards measuring the net investment income per share over a specified 30-day period expressed as a percentage of the maximum offering price of the Fund's shares at the end of the period.

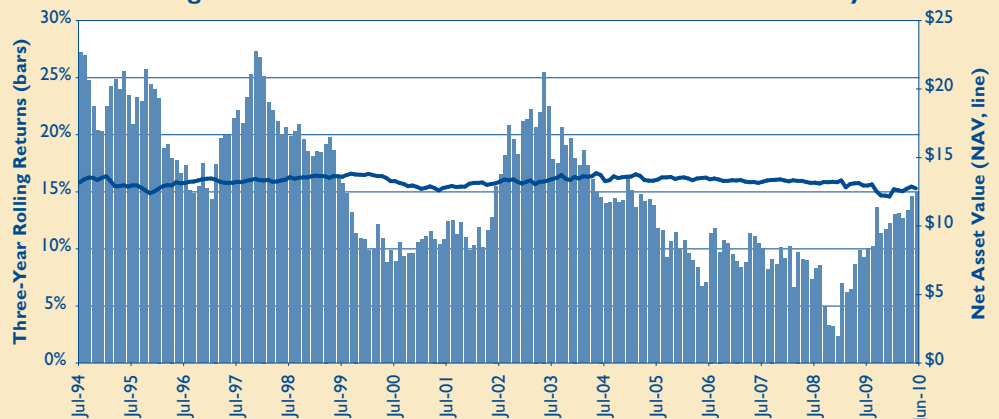
Sacrifice Performance to Reduce Volatility? – Not Always!

Average Annual Total Returns as of 6/30/10, without sales charge



Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit thornburg.com. If sales charges were deducted, performance would be lower.

Thornburg Intermediate Municipal Fund (A Shares) Rolling Three-Year Performance and Net Asset Value History



Since the inception of the Intermediate Municipal Fund, there have been no three-year periods with negative performance. Regardless of when the initial investment was made, investors holding the fund for at least three years would have experienced positive returns.

Rolling returns are useful for examining the behavior of returns for holding periods similar to those actually experienced by investors. Rolling performance in the chart above represents three-year periods, updated monthly. Performance is cumulative and given before sales charges. Had sales charges been taken into account, returns would have been lower.

Diversifying Along the Yield Curve

by **Chris Ryon, CFA**
Portfolio Manager

Tremendous amounts of assets have flowed into short-term municipal bond funds, primarily out of municipal money market funds. Many investors feel they are limiting their risk by owning short-duration bond funds. Duration is a measure of a bond's price sensitivity to changes in interest rates. Duration is one factor that determines the performance of a bond or bond fund. The other is how interest rates change. Interest rates do not always move in a parallel fashion (same amount for each maturity) especially in periods when the Federal Reserve Board is actively increasing short-term interest rates. Predicting the direction of interest rates, let alone their relative change along the yield curve, is an impossible task. Many try, a few get lucky, and even fewer repeat on a consistent basis. What is an investor to do? Use a tried

and true risk management technique and diversify these risks.

Wikipedia defines diversification as follows:

"In risk management, the act or strategy of adding more investments to one's portfolio to hedge against the investments already in it. Ideally, this reduces the risk inherent in any one investment, and increases the possibility of making a profit, or at least avoiding a loss. This may also reduce the expected return on a portfolio, but it depends on the level and type of diversification. There are two main types of diversification. Horizontal diversification involves investing in similar investments. Examples include investing in several technology companies or in different types of bonds. Vertical diversification involves investing in very different securities; for example, one may choose to invest in securities traded

in different countries, or in both winter clothing and swimsuit companies. Both types of diversification may be as broad or as narrow as the investor chooses. In general, broader diversification equates to less risk and less return."

We will discuss the benefits of "horizontal diversification" in the municipal market. To do this we will examine the benefits of diversification in two recent bear markets. We defined a bear market as one in which the Federal Reserve Board is engaged in a prolonged strategy of raising short-term interest rates. We will first illustrate how the municipal bond market responded to the Federal Reserve Board's action by analyzing how the General Obligation AAA yield curve and its slope changed. Then we will examine how the Thornburg Limited Term Municipal Fund and the Thornburg Intermediate Municipal Fund performed in these periods. Finally, we will show how investors could have benefited from diversifying between these two funds in these bear markets.

rose in the 1-10 year segment of the municipal bond market, but contrary to the 1994-1995 bear market, interest rates decreased in the 15-30 year segment of the market. The slope of the yield curve flattened by 249 basis points (2.49%). Again most of the slope change took place in the 1-5 year segment of the market.

Fund Performance During Bear Markets

Table III illustrates the bear market returns for the Thornburg Limited Term Municipal Fund (A shares - LTMFX) and the Thornburg Intermediate Municipal Fund (A shares - THIMX). In addition, we have included the returns for the bear market period plus an additional 12 months. This was done to introduce the concept of holding period returns and the importance of having the right investment horizon for your investments, especially fixed income investments.

In the bear market of 2/4/1994-2/1/1995, LTMFX outperformed THIMX by 41 basis points (0.41%). This is due to interest rates rising across the yield curve with the greatest increase occurring in the short end of the yield curve. The increase in short-end interest rates was not great enough, relative to the increase in longer-term interest rates, to offset the impact of the funds' relative durations. THIMX's price return of -6.29% (yield change x duration) was far less than LTMFX's price return of -5.45%. The difference in price return (-0.84%) was reduced by THIMX's higher income, to generate a total return differential of -0.41%.

An interesting phenomena occurred in the next 12

Maturity	AAA GO 2/4/94	AAA GO 2/1/95	Change
1-Yr	2.45%	4.63%	2.18%
2-Yr	2.93%	4.78%	1.85%
3-Yr	3.31%	4.88%	1.57%
4-Yr	3.54%	4.98%	1.44%
5-Yr	3.76%	5.08%	1.32%
7-Yr	4.08%	5.28%	1.20%
10-Yr	4.39%	5.58%	1.19%
15-Yr	4.86%	5.93%	1.07%
20-Yr	5.03%	6.08%	1.05%
25-Yr	5.05%	6.14%	1.09%
30-Yr	5.08%	6.18%	1.10%
Slope			
1-5	1.31	0.45	-0.86
5-10	0.63	0.50	-0.13
10-30	0.69	0.60	-0.09
1-30	2.63	1.55	-1.08

Maturity	AAA GO 6/30/04	AAA GO 6/29/06	Change
1-Yr	1.56%	3.71%	2.15%
2-Yr	2.11%	3.77%	1.66%
3-Yr	2.54%	3.81%	1.27%
4-Yr	2.88%	3.86%	0.98%
5-Yr	3.15%	3.91%	0.76%
7-Yr	3.56%	4.03%	0.47%
10-Yr	4.02%	4.23%	0.21%
15-Yr	4.50%	4.47%	-0.03%
20-Yr	4.82%	4.55%	-0.27%
25-Yr	4.93%	4.58%	-0.35%
30-Yr	4.93%	4.59%	-0.34%
Slope			
1-5	1.59	0.20	-1.39
5-10	0.87	0.32	-0.55
10-30	0.91	0.36	-0.55
1-30	3.37	0.88	-2.49

Municipal Bond Market & Rising Fed Funds Rate

Table I illustrates the changes in the General Obligation AAA yield curve between February 4, 1994, and February 1, 1995. Interest rates rose across the entire yield curve with the greatest increases taking place in the short end of the market. The slope of the entire yield curve declined 108 basis points (1.08%). Most of the slope change came in the 1-5 year maturity segment of the market.

As illustrated in table II, between June 30, 2004, and June 29, 2006, interest rates

Table III**Bear Market Returns**

2/4/94 – 2/1/95			
	Price Return	Income Return	Total Return
THIMX	-6.29%	5.05%	-1.24%
LTMFX	-5.45%	4.62%	-0.83%
Difference	-0.84%	0.43%	-0.41%

6/30/04 – 6/29/06 (Annualized Returns)

	Price Return	Income Return	Total Return
THIMX	-0.68%	3.73%	3.05%
LTMFX	-1.29%	3.02%	1.73%
Difference	0.61%	0.71%	1.32%

Bear Market + 12 Month Returns

2/4/94 – 2/1/96 (Annualized Returns)			
	Price Return	Income Return	Total Return
THIMX	-0.41%	5.36%	4.95%
LTMFX	-0.73%	4.84%	4.11%
Difference	0.32%	0.52%	0.84%

6/30/04 – 6/29/07 (Annualized Returns)

	Price Return	Income Return	Total Return
THIMX	-0.40%	3.78%	3.38%
LTMFX	-0.81%	3.16%	2.35%
Difference	0.41%	0.62%	1.03%

Table IV**30-day Yields**

	Distribution Yields			SEC Yields
	1/31/94	6/30/04	6/30/10	6/30/10
THIMX	4.80%	3.99%	3.64%	2.78%
LTMFX	4.33%	2.83%	2.68%	1.90%
Difference	0.47%	1.16%	0.96%	0.88%

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit thornburg.com. Returns do not include the deduction of sales charges. If sales charges were deducted, performance would be lower.

Diversification does not assure or guarantee better performance and cannot eliminate the risk of investment losses.

Source of all fund data is Thornburg Investment Management.

months, the yield curve changed shape again. Long-term interest rates rallied more than short-term interest rates as market participants realized the Federal Reserve Board was serious about fighting inflation. This translated into the outperformance of THIMX vs. LTMFX, on an annualized total return basis, for the two-year period by 0.84%.

In the second bear market (6/30/2004–6/29/2006), THIMX outperformed LTMFX by 1.32%. This is due to the fact that short-term interest rates rose and long-term interest rates declined during the period. If we extend the holding period by 12 months, we see that THIMX still outperformed LTMFX by a slightly less 1.03% annualized total return.

As shown in table IV, at the start of the 1994 bear market the spread in distribution yield between LTMFX and THIMX was approximately 47 basis points (0.47%) and over the next 12 months LTMFX outperformed THIMX. At the start of the 2004 bear market, the yield spread stood at 116 basis points (1.16%) and THIMX outperformed LTMFX over the next two

Table V**Bear Market Returns**

2/4/94 – 2/1/95			
	Price Return	Income Return	Total Return
75 LTMFX / 25 THIMX Mix	-5.66%	4.73%	-0.93%
50 LTMFX / 50 THIMX Mix	-5.87%	4.83%	-1.04%
25 LTMFX / 75 THIMX Mix	-6.08%	4.94%	-1.14%

6/30/04 – 6/29/06 (Annualized Returns)

	Price Return	Income Return	Total Return
75 LTMFX / 25 THIMX Mix	-1.14%	3.20%	2.06%
50 LTMFX / 50 THIMX Mix	-0.99%	3.38%	2.39%
25 LTMFX / 75 THIMX Mix	-0.83%	3.55%	2.72%

Bear Market + 12 Month Returns

2/4/94 – 2/1/96 (Annualized Returns)			
	Price Return	Income Return	Total Return
75 LTMFX / 25 THIMX Mix	-0.65%	4.97%	4.32%
50 LTMFX / 50 THIMX Mix	-0.57%	5.10%	4.53%
25 LTMFX / 75 THIMX Mix	-0.49%	5.23%	4.74%

6/30/04 – 6/29/07 (Annualized Returns)

	Price Return	Income Return	Total Return
75 LTMFX / 25 THIMX Mix	-0.71%	3.32%	2.61%
50 LTMFX / 50 THIMX Mix	-0.61%	3.47%	2.87%
25 LTMFX / 75 THIMX Mix	-0.50%	3.63%	3.12%

years. On June 30, 2010, the yield spread between the two funds was 96 basis points (0.96%).

The Benefits of Horizontal Diversification

As we can see from the above scenarios, the way interest rates change along the yield curve impacts the relative performance of short- and intermediate-term funds. An investor may insulate themselves from being caught in the wrong segment of the market by diversifying

holdings along the yield curve. Table V shows us what the returns would have been if a portfolio included various mixes of LTMFX and THIMX in the two bear markets we have been discussing.

From the perspective of a hypothetical shareholder invested 100% in LTMFX, adding a portion of THIMX increases their loss in the 2/4/1994–2/1/1995 bear market but their gains are magnified in all other scenarios we have discussed. Compared to the 100%

THIMX portfolio, losses are reduced in the 2/4/1994–2/1/1995 bear market and so are the potential gains in all other scenarios we have discussed. So, as we can see, diversifying along the yield curve has the potential to limit losses and add to a portfolio's annualized total returns, depending on how the yield curve changes. Since this is unknown ahead of the event, the best way an investor can protect themselves from adverse interest rate changes is to diversify their holdings along the yield curve. ■

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View *from the* Bond Desk



Back row: Josh Gonze, Lon Erickson, Chris Ihlefeld, Jason Brady
Front row: George Strickland, Yvette Garcia, Chris Ryon

Inside:

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**Managing Municipal
Credit Risk**

**Global Debt and
its Ramifications**

**Sacrifice Performance
to Reduce Volatility?
– Not Always!**

**Diversifying Along
the Yield Curve**

Bond Trivia

 **Ownership of Municipal Debt**
(in billions of dollars)

	Q1 2010	Q4 2009	Change
Households	1,020.1	998.9	2.1%
Mutual funds	500.7	480.2	4.1%
Property-casualty insurance companies	372.8	369.4	0.9%
Money market funds	368.7	401.3	-8.8%
Commercial banks	218.6	219.3	0.3%
Broker dealers	40.3	35.4	12.2%
Other	300.0	312.4	4.0%
Total outstanding municipal debt	2,834.3	2,803.7	1.1%

Source: Federal Reserve, "Flow of Funds Accounts of the United States, Flows and Outstandings, First Quarter 2010," June 10, 2010.

Performance Supplement to View from the Bond Desk

Performance data shown represents past performance and is no guarantee of future results. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than quoted. For performance current to the most recent month end, visit thornburg.com or call 877-215-1330.

The Limited Term funds have a maximum sales charge of 1.50% for the A shares and a 0.50% contingent deferred sales charge (CDSC) on the C shares for the first year only. The Strategic Municipal Income Fund and the Intermediate Term funds have a maximum sales charge of 2.00% for the A shares and a 0.60% CDSC on the C shares for the first year only. The Strategic Income Fund has a maximum sales charge of 4.50% for class A shares and a 1.00% CDSC on C shares for the first year only. There is no up-front sales charge for class I shares.

Thornburg Investment Management and Thornburg Securities Corporation have contractually agreed to waive fees and reimburse expenses through at least February 1, 2013, so that actual expenses do not exceed the subsidized expense ratio. Without these waivers and reimbursements, SEC Yields would have been as follows: Strategic Income Fund A shares, 5.63% and C shares, 5.13%.

Performance as of December 31, 2011

	Average Annual Total Returns				Since Incep.	30-Day SEC Yield	Annual Operating Expense Ratios	
	1 Yr	3 Yrs	5 Yrs	10 Yrs			Subsidized	Total
Limited Term Income Fund								
Class A Shares (THIFX Inception: 10/1/92)								
Without sales charge	5.08%	9.18%	5.88%	4.96%	5.62%	2.59%	–	0.98%
With sales charge	3.50%	8.62%	5.56%	4.80%	5.54%			
Class C Shares (THICX Inception: 9/1/94)								
Without sales charge	4.82%	8.89%	5.62%	4.68%	5.35%	2.35%	–	1.23%
With sales charge	4.32%	8.89%	5.62%	4.68%	5.35%			
Class I Shares (THIIX Inception: 7/5/96)								
	5.45%	9.52%	6.24%	5.30%	5.92%	2.97%	–	0.63%
Limited Term U.S. Government Fund								
Class A Shares (LTUSX Inception: 11/16/87)								
Without sales charge	3.73%	3.75%	4.95%	4.28%	5.79%	0.94%	–	0.89%
With sales charge	2.17%	3.22%	4.64%	4.12%	5.73%			
Class C Shares (LTUCX Inception: 9/1/94)								
Without sales charge	3.44%	3.45%	4.64%	3.97%	4.79%	0.65%	–	1.16%
With sales charge	2.94%	3.45%	4.64%	3.97%	4.79%			
Class I Shares (LTUIX Inception: 7/5/96)								
	4.15%	4.07%	5.27%	4.59%	5.35%	1.28%	–	0.57%
Strategic Income Fund								
Class A Shares (TSIAX Inception: 12/19/07)								
Without sales charge	4.44%	17.31%	–	–	7.59%	5.66%	1.25%	1.32%
With sales charge	-0.25%	15.51%	–	–	6.37%			
Class C Shares (TSICX Inception: 12/19/07)								
Without sales charge	3.85%	16.69%	–	–	6.99%	5.38%	1.80%	2.07%
With sales charge	2.89%	16.69%	–	–	6.99%			
Class I Shares (TSIIX Inception: 12/19/07)								
	4.80%	17.68%	–	–	7.91%	6.28%	–	0.98%

Investments in the Funds carry risks, including possible loss of principal. Bond funds have the same interest rate, inflation and credit risks that are associated with the underlying bonds owned by a fund. The principal value of bond funds will fluctuate relative to changes in interest rates, decreasing when interest rates rise. This effect is more pronounced for longer term bonds. Unlike bonds, bond funds have ongoing fees and expenses. Funds invested in mortgage backed securities may bear additional risk. Investments in lower rated and unrated bonds may be more sensitive to default, downgrades, and market volatility; these investments may also be less liquid than higher rated bonds. Investments in derivatives are subject to the risks associated with the securities or other assets underlying the pool of securities, including illiquidity and difficulty in valuation. Investments in equity securities are subject to greater market fluctuations than bond securities. Special risks may be associated with investments outside the United States, especially in emerging markets, including currency fluctuations, illiquidity and volatility. Investments in small capitalization companies may increase the risk of greater price fluctuations. Investments in the Funds are not FDIC insured, nor are they deposits of or guaranteed by a bank or any other entity.

Thornburg Investment Management and Thornburg Securities Corporation have contractually agreed to waive fees and reimburse expenses through at least February 1, 2013, so that actual expenses do not exceed the subsidized expense ratio. Without these waivers and reimbursements, SEC Yields would have been as follows: Intermediate Municipal Fund - C, 1.95%; New York Intermediate Municipal Fund - A, 1.46%; I, 1.80%; Strategic Municipal Income Fund - A, 3.51%; C, 3.11%; I, 3.93%.

Before investing, carefully consider the Fund's investment goals, risks, charges, and expenses. For a prospectus containing this and other information, contact your financial advisor or visit thornburg.com or call 877-215-1330. Read it carefully before investing.

Performance as of December 31, 2011

	Average Annual Total Returns				Since Incep.	30-Day SEC Yield	Annual Operating Expense Ratios	
	1 Yr	3 Yrs	5 Yrs	10 Yrs			Subsidized	Total
Limited Term Municipal Fund								
Class A Shares (LTMFX Inception: 9/28/84)								
Without sales charge	6.70%	6.15%	4.65%	3.97%	5.53%	1.34%	—	0.74%
With sales charge	5.11%	5.62%	4.33%	3.82%	5.47%			
Class C Shares (LTMCX Inception: 9/1/94)								
Without sales charge	6.41%	5.89%	4.37%	3.69%	3.93%	1.08%	—	1.00%
With sales charge	5.91%	5.89%	4.37%	3.69%	3.93%			
Class I Shares (LTMIX Inception: 7/5/96)								
	7.06%	6.50%	4.99%	4.32%	4.59%	1.69%	—	0.40%
Intermediate Municipal Fund								
Class A Shares (THIMX Inception: 7/22/91)								
Without sales charge	9.49%	8.47%	4.73%	4.50%	5.29%	2.28%	—	0.95%
With sales charge	7.27%	7.74%	4.31%	4.29%	5.19%			
Class C Shares (THMCX Inception: 9/1/94)								
Without sales charge	9.16%	8.17%	4.44%	4.20%	4.41%	2.02%	1.24%	1.232%
With sales charge	8.56%	8.17%	4.44%	4.20%	4.41%			
Class I Shares (THMIX Inception: 7/5/96)								
	9.76%	8.79%	5.06%	4.84%	4.96%	2.65%	—	0.63%
California Limited Term Municipal Fund								
Class A Shares (LTCAX Inception: 2/19/87)								
Without sales charge	6.74%	6.13%	4.47%	3.68%	4.80%	1.40%	—	0.96%
With sales charge	5.13%	5.59%	4.16%	3.53%	4.73%			
Class C Shares (LTCCX Inception: 9/1/94)								
Without sales charge	6.46%	5.85%	4.20%	3.40%	3.75%	1.14%	—	1.22%
With sales charge	5.94%	5.85%	4.20%	3.40%	3.75%			
Class I Shares (LTCIX Inception: 4/1/97)								
	7.09%	6.48%	4.80%	4.03%	4.30%	1.75%	—	0.63%
New York Intermediate Municipal Fund								
Class A Shares (THNYX Inception: 9/5/97)								
Without sales charge	9.70%	6.70%	4.82%	4.15%	4.45%	1.54%	0.99%	1.07%
With sales charge	7.52%	5.99%	4.40%	3.94%	4.30%			
Class I Shares (TNYIX Inception: 2/1/10)								
	10.05%	—	—	—	6.38%	1.89%	0.67%	0.71%
New Mexico Intermediate Municipal Fund								
Class A Shares (THNMX Inception: 6/18/91)								
Without sales charge	7.80%	6.24%	4.52%	4.18%	4.97%	1.58%	—	0.96%
With sales charge	5.64%	5.53%	4.10%	3.96%	4.87%			
Class D Shares (THNDX Inception: 6/1/99)								
Without sales charge	7.55%	5.94%	4.24%	3.90%	3.88%	1.68%	—	1.22%
Class I Shares (THNIX Inception: 2/1/07)								
	8.16%	6.58%	—	—	5.00%	1.96%	—	0.62%
Strategic Municipal Income Fund								
Class A Shares (TSSAX Inception: 4/1/09)								
Without sales charge	12.40%	—	—	—	11.99%	3.58%	1.25%	1.38%
With sales charge	10.16%	—	—	—	11.18%			
Class C Shares (TSSCX Inception: 4/1/09)								
Without sales charge	12.06%	—	—	—	11.69%	3.35%	1.55%	1.83%
With sales charge	11.46%	—	—	—	11.69%			
Class I Shares (TSSIX Inception: 4/1/09)								
	12.70%	—	—	—	12.30%	3.93%	0.99%	1.03%