

2nd Quarter 2010 Portfolio Manager Market Commentary
Thornburg Municipal Bonds



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The second quarter was a good three months to own municipal bonds, as nearly every sector generated positive returns. At this juncture, with sparse evidence of inflation in the economic air, rising tax rates, and early indications of economic recovery, it appears to be a good time to continue to hold those bonds.

Certainly the second quarter of 2010 was satisfactory for bondholders, with positive returns across broad market indexes and also in narrower sectors. The Merrill Lynch Municipal Master Index was +2.02% for the quarter. It didn't make much difference where on the yield curve you were positioned, as the 1-5 year index recorded a 0.89% gain, the 1-12 year index was +1.92%, and the 15+ year index was +2.08%. Interest rates continued their decline in the first 20 years of the yield curve and were roughly stable in the latter years. For example, ten-year, triple-A municipals were yielding around 3.28% at the beginning of April and around 3.09% at the end of June.

While municipal credit concerns have diminished in recent weeks, negative newspaper articles about public finance seem to be sprouting weekly, like weeds in an increasingly lush lawn. In addition to the headline risk created by newspapers, we still perceive a heightened degree of credit risk arising from state budget pressures and falling real estate prices.

We are happy to report that recent data on state tax revenue has been somewhat encouraging, though it still trails pre-recession levels. According to U.S. Census Bureau data, in the first quarter of 2010, state and local government tax collections totaled \$299.1 billion, a 0.82% increase from the prior year. Revenues from the three major taxes were \$138 billion in the first quarter of 2010 versus \$135 billion and \$155 billion in the first quarters of 2009 and 2008, respectively. 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. It appears that municipal finance has begun a long and rocky road to recovery.

California and New York reported the largest percentage increases, 15.8% in New York and 19.1% in California. Louisiana reported the largest decrease, 32.8%, compared to last year. Often we

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Past performance does not guarantee future results.

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are asked about California's prospects, given its persistent structural budget deficit and political gridlock. We observe that per the state constitution, debt service is ranked second in priority after schools, and that in 2009, when the state issued IOUs to vendors instead of paying in cash, debt service was uninterrupted.

The Fed is holding a steady hand on the funds rate, which is effectively zero, with no increase in sight. Until it detects inflation pressures in the economic data, Fed governors will likely leave the short end of the yield curve anchored at the bottom.

We're acutely aware of investors' credit concerns and we're taking several concrete steps to mitigate the risk of defaults within our portfolio. 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 bonds that depend on economic growth in a region of severe economic distress, e.g. the City of Detroit. 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.

We ladder the maturity dates of the bonds in your portfolio so that some of the bonds are scheduled to mature during each of the coming years. Laddering short and intermediate bonds accomplishes two goals. First, the staggered maturities contained in a ladder defuse interest-rate risk and dampen the Fund's price volatility. Second, laddering gives the portfolio a steady cash flow stream from maturing bonds to reinvest toward the top end of the ladder where yields are typically higher.

Over the years, our practice of laddering a diversified portfolio of short and intermediate municipal bonds has produced consistently good results in varying interest rate and economic environments. Thank you for investing with Thornburg Investment Management.

Important Information

The views expressed by the Portfolio Managers reflect their professional opinions and should not be considered buy or sell recommendations. These views are subject to change.

BofA Merrill Lynch Municipal Master Index – The BofA Merrill Lynch Municipal Master Index tracks the performance of the investment-grade U.S. tax-exempt bond market. Qualifying bonds must have at least one year remaining term to maturity, a fixed coupon schedule, and an investment grade rating (based on average of Moody's, S&P, and Fitch).

Securities and sectors mentioned are presented for the general information of Fund shareholders. Portfolio holdings are subject to change daily. Under no circumstances does the information contained within represent a recommendation to buy or sell securities.

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

Swaps – An agreement to swap interest rate exposures from floating to fixed or vice versa. There is no swap of the principal. It is the interest cash flows be they payments or receipts that are exchanged.

Revenue Bond – A bond on which the debt service is payable solely from the revenue generated from the operation of the project being financed or a category of facilities, or from other non-tax sources.

Tax-exempt bonds may be subject to the alternative minimum tax.

The Fed Funds Rate is the interest rate at which a depository institution lends immediately available funds (balances at the Federal Reserve) to another depository institution overnight.

Treasuries are negotiable debt obligations of the U.S. government backed by the "full faith and credit" of the government and issued at various schedules and maturities. Income from Treasury securities is exempt from state and local, but not federal, taxes. Treasury Bills are short-term instruments with maturities of no more than one year. Treasury bills function like zero-coupon bonds. Investors buy bills at a discount

from the par, or face value and then receive the full amount when the bill matures. Treasury Notes are intermediate to long term investments typically issued in maturities of two, five and ten years. Interest is paid semi-annually. Treasury Bonds cover terms of more than ten years and are currently issued only in maturities of 30 years. Interest is paid semi-annually.

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

A bond credit rating assesses the financial ability of a debt issuer to make timely payments of principal and interest. Ratings between AAA (the highest) and BBB are investment-grade quality. Ratings of BB and below are considered speculative grade, or junk bonds. Unless otherwise noted, the ratings listed are from Municipal Market Data and are a combination of ratings from Standard and Poor's, Moody's Investors Service, and Fitch Ratings.

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