Eaton Vance Investment Managers

Discover Enduring Values

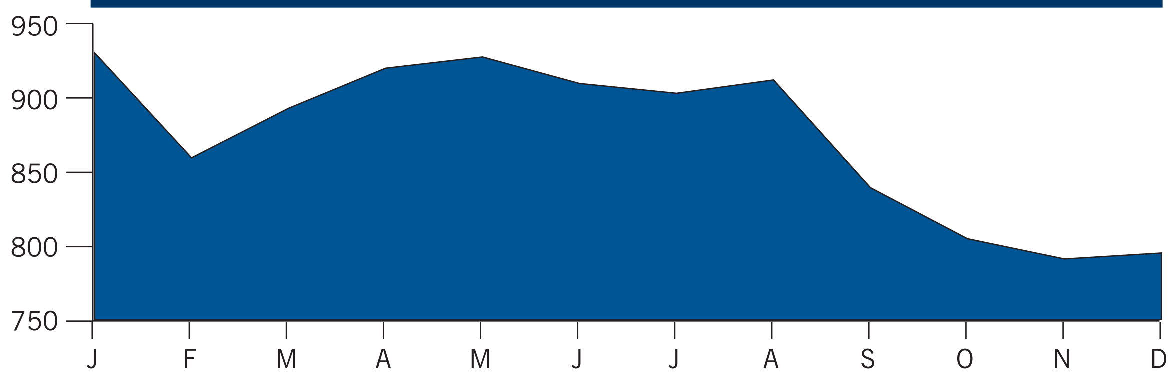
# The Municipal Bond Opportunity:

**High-quality investments, low risk of default and tax-exempt income—all at a price discount for the record books**

**February 2009**

The 2008 performance of the municipal bond market has some investors worried about a seismic shift in muni fundamentals and a broad deterioration in municipal credit quality. Who can blame them? Municipal bonds just limped through their worst calendar-year performance in history, leaving longtime muni investors – accustomed to the historical stability of the asset class – bewildered by never-before-seen volatility. Consider the chart below, which shows the dramatic and quick decline of municipal values in 2008.

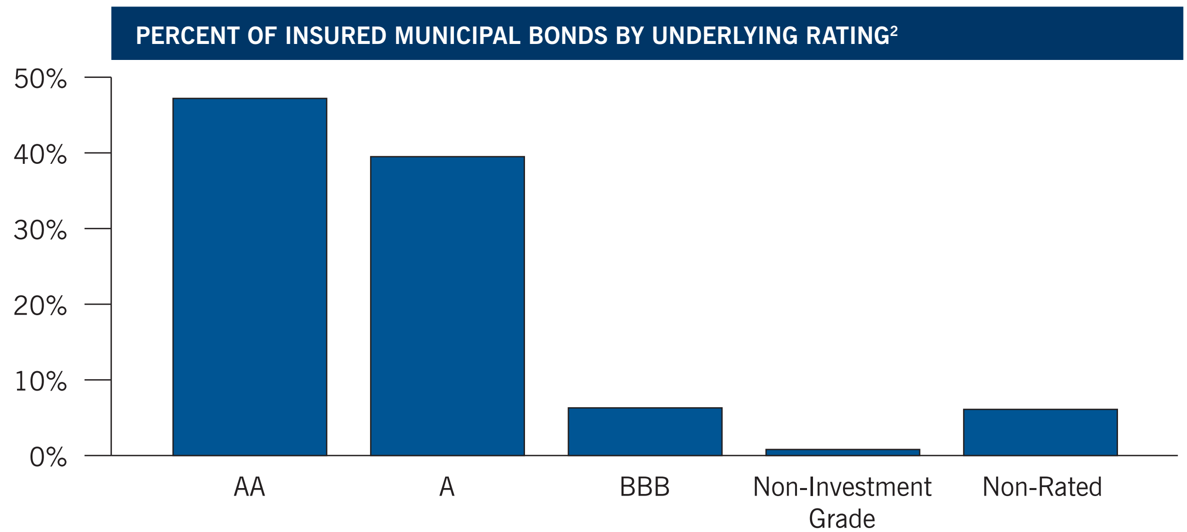
**2008 LONG-TERM MUNICIPAL BOND INDEX VALUES**[1]




Notwithstanding the year's municipal price experience, however, the credit quality of municipal securities remains high. In fact, nearly 90% of munis have underlying credit ratings – that is, the ratings before bond insurance is added – of AA or A.[2] And all but 7% of munis are rated investment grade (BBB or higher).[2] These high ratings are the result of municipals' long history of reliable repayment; legal authority to raise taxes, rates and fees; and the historically reliable income streams of municipal projects.

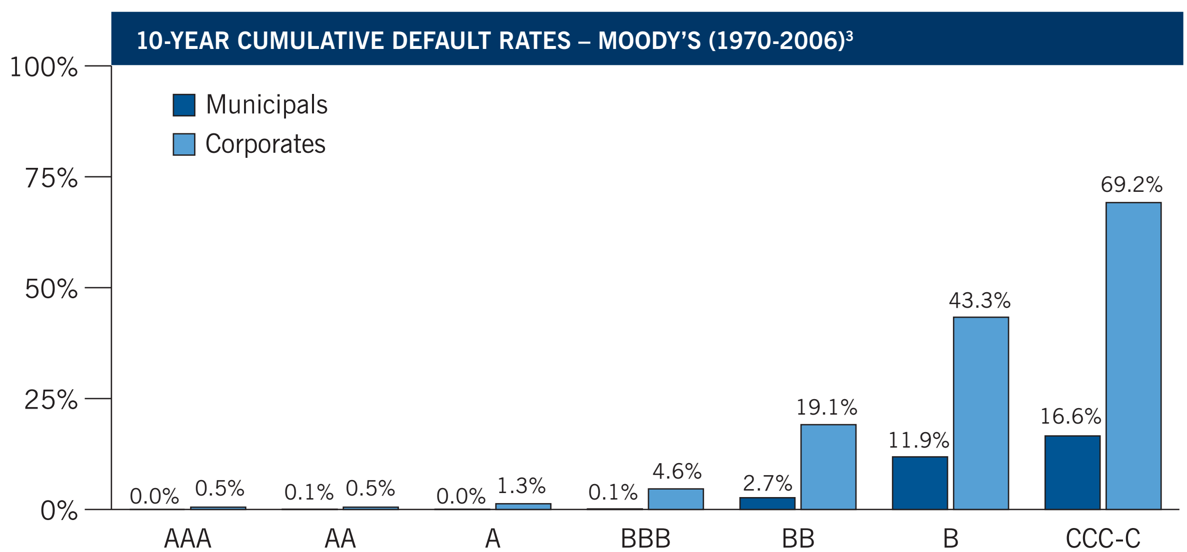
[1] Source: Barclays Capital, Barclays Capital 22+ Municipal Bond Index

[2] Source: Municipal Market Advisors 1/2008




## Municipals exhibit extremely low historical default rates

Given their high ratings and long history of repaying their lenders, it follows that the muni default rate is extremely low. In fact, since the 1970s, municipals have exhibited significantly lower risk of default than similarly rated corporate bonds. As shown in the chart, the default performance of municipals has been outstanding.




[2] Source: Municipal Market Advisors 1/2008

[3] Source: Moody's Investor Services

## If not muni fundamentals, what was the problem?

In our view, it was primarily “technical factors” such as limited institutional buyers, industry-wide bond fund redemptions and a growing number of sellers in the market (deleveraging muni hedge funds, for example). Taken together, these factors resulted in an overall supply/demand imbalance in municipals, not a fundamental shift in the market.

Why did buyers back away from munis in 2008? In the case of institutional buyers, the evolution of the “subprime” crisis resulted in growing regulatory capital needs for Wall Street firms, many of which no longer had the capacity to invest in munis and needed to focus capital elsewhere on their balance sheets. As a result, institutional buyers were largely absent last year.

On the retail side of the market – which traditionally constitutes roughly two-thirds of municipal demand – investors skittishly shied away, as they were blasted with report after report of “problems” in municipals. Given that retail investors tend to be more reactive to the news and short-term performance swings than institutional investors, it’s really no surprise that retail muni demand shrank in 2008.

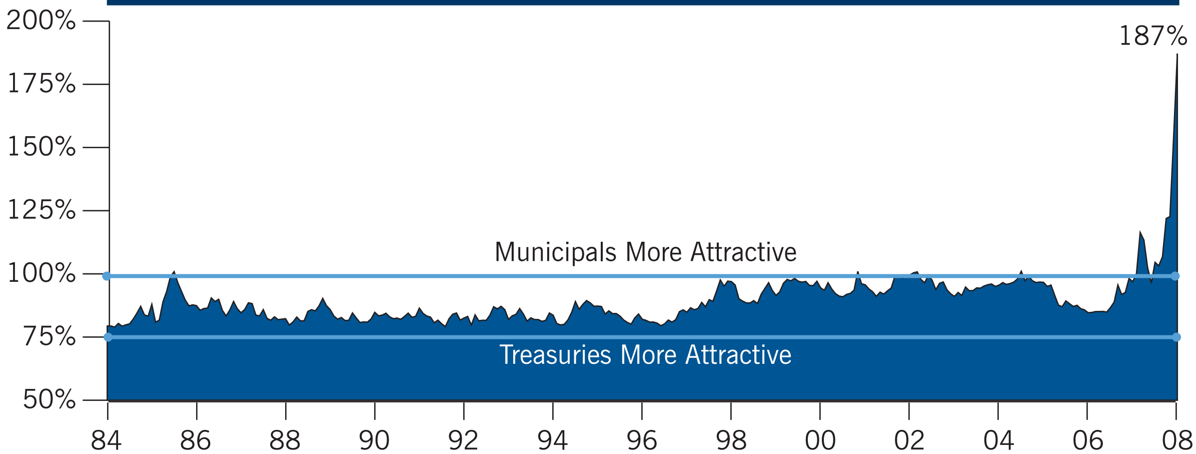
There were other issues, too – such as the rapid and substantial downgrading of municipal bond insurers. This was caused by insurers’ guarantees of structured “subprime” products that began to unravel with the credit crunch. While insured munis remained fundamentally sound, the continued downgrading of the insurers led the municipal market lower, as investors began to question whether the insurers could fulfill their guarantees if necessary, given their exposure to riskier securities. While problematic for munis, this development was not a fundamental issue.

## The result? Unprecedented value in municipal bonds

Consider the chart on the next page, which shows the historical relationship of yields between 30-year high-quality municipals and 30-year taxable Treasury bonds.[4] Typically, munis yield less than Treasuries – given their tax exemption – and, historically, have yielded between 75%-100% of Treasuries over time. At higher ratios, munis represent more value. Lower ratios mean Treasuries are more attractive.

[4] Source: Barclays Capital 12/2008. The ratio shown is that of the yield on a 30-year municipal bond index tracked by Barclays Capital to the yield of a 30-year U.S. Treasury bond.

**30-YEAR AAA MUNICIPAL-TO-TREASURY YIELD RATIO[4]**




At the end of 2008, the ratio reached 187%, translating into tremendous opportunity for muni buyers: high-quality, tax-exempt investments at attractive yields – and at price levels that allow for significant capital appreciation potential.

## Bifurcated performance creates bifurcated opportunity

While municipals as a whole underperformed in 2008, the performance of the muni market was bifurcated by maturity. The segments of the municipal yield curve performed dramatically different, with longer-maturity munis significantly underperforming shorter maturities. As the decline in demand for munis was principally concentrated in the longer end of the municipal yield curve, short munis benefited as investors, some of whom were reluctant to leave the asset class for Treasuries, rushed into shorter-maturity municipal bonds as a safety play.

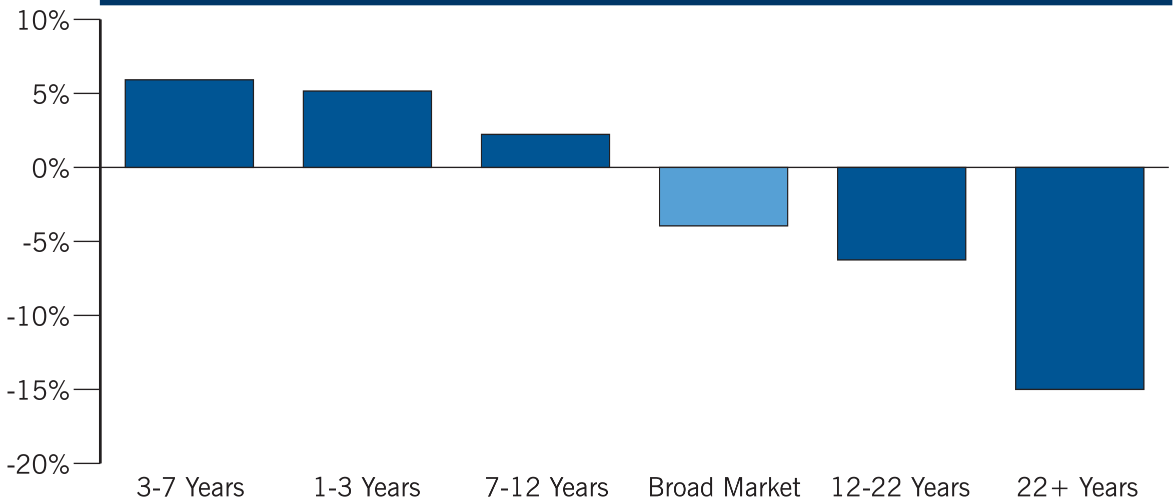
This performance bifurcation has created opportunities, especially for the longest-maturity muni bonds. While the old saying goes, "what goes up must come down," typically the reverse is also true in bonds – assuming bonds are held to maturity – given the accretion to par values as maturities approach. This, along with the depressed muni values of 2008, translates into greater opportunity in longer-term municipal bonds.

## Longer-term municipals best positioned for rebound

Longer-term municipals typically pay investors higher levels of tax-exempt income due to the historically upward-sloping shape of the municipal yield curve. What's more, this segment of the muni curve offers capital appreciation upside potential seen only a few times in the history of the muni market. Consider the chart on the next page, which shows that the greatest upside potential in the muni market may be found within the 22-year+ sector of the municipal yield curve (those muni bonds with maturities of 22 years and longer).

[4] Source: Barclays Capital 12/2008. The ratio shown is that of the yield on a 30-year municipal bond index tracked by Barclays Capital to the yield of a 30-year U.S. Treasury bond.

**2008 MUNICIPAL PERFORMANCE BY MATURITY SEGMENT[5]**

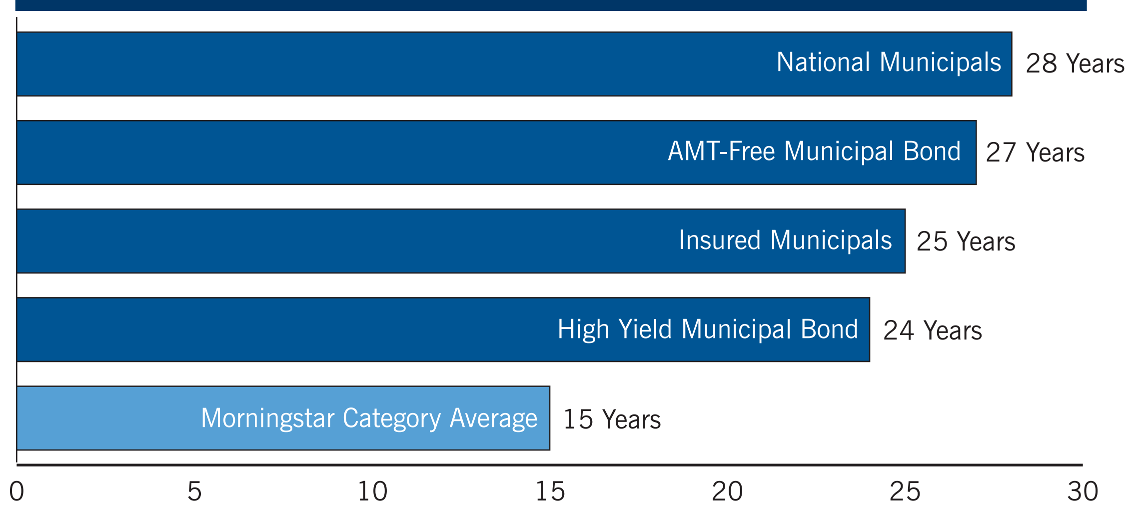



## Take advantage

Taking advantage of the dislocation in municipals is easy. At Eaton Vance, our municipal bond team manages a suite of mutual funds with a bias toward longer maturity municipal investing. We manage four long-term national funds, with average maturities of 24 years or greater,[6] compared with the 15-year average maturity offered by the average Morningstar Muni National Long Category fund.

With significantly longer average maturities than those available elsewhere, the Eaton Vance lineup of long-term municipal funds offers investors the opportunity to take advantage of greater upside potential in the muni market.

**AVERAGE MATURITY (YEARS) – MUNI NATIONAL LONG CATEGORY FUNDS[7]**




[5] Source: Morningstar, 12/2008. Indices shown are Merrill Lynch Municipal Bond Indices for maturity segments shown. Broad market is represented by the Merrill Lynch Municipal Master Index. Past performance is no guarantee of future results. See last page for index descriptions. It is not possible to invest directly in an index.

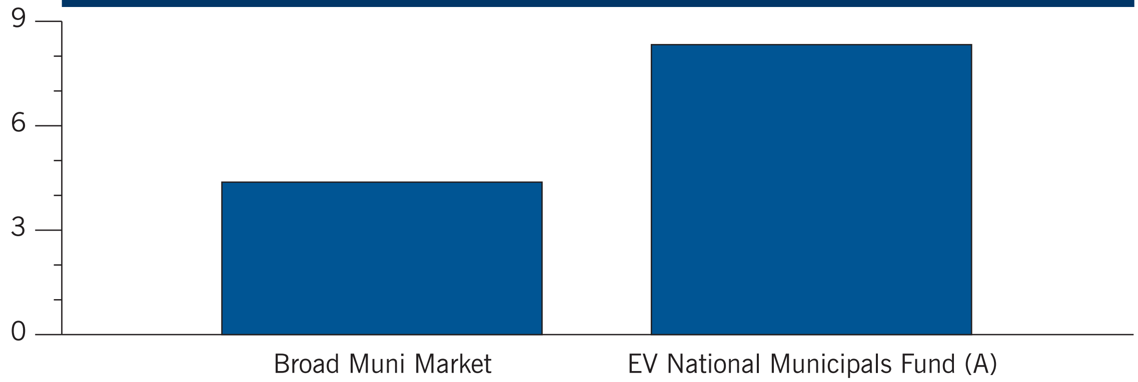
[6] As of 12/31/2008

[7] Source: Morningstar / Eaton Vance 9/2008

## Investing in longer-term muni bonds means greater price volatility

While representing the most upside potential in the municipals market, long-term munis – like longer-term bonds of any asset class – typically have greater price volatility (i.e., price fluctuation) than shorter-maturity alternatives. As a result, it's not surprising to see that municipal funds focused on the longest segments of the municipal yield curve – such as the four long-term national funds managed by Eaton Vance, including National Municipals Fund – typically have higher measures of price volatility than many competitor funds with shorter average maturities. One measure of price volatility is standard deviation, which is shown in the chart below. Compare the price volatility of National Municipals to that of the broad municipals market, which includes short-, intermediate- and long-term municipals.

**10-YEAR STANDARD DEVIATION[8]**

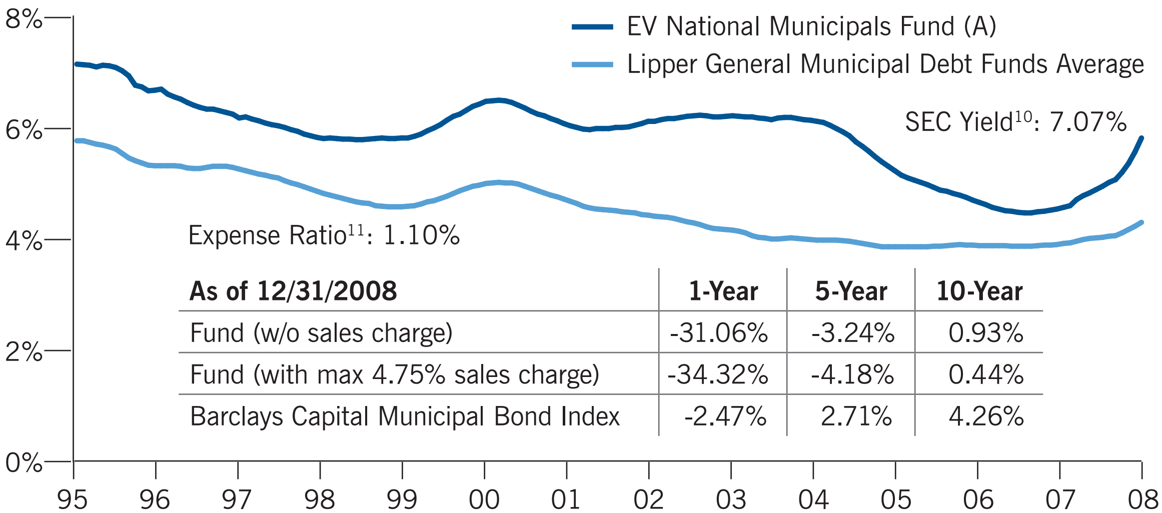



## Higher volatility trade-off: higher levels of tax-exempt income

As discussed earlier, longer-maturity muni investors are generally rewarded with higher levels of tax-exempt income. The chart on the next page illustrates the income return – that is, the return associated with coupon income, rather than price appreciation – of Eaton Vance National Municipals Fund relative to that of the average of the municipal funds included in the Lipper General Municipal Debt Funds Average.

[8] Source: Morningstar 12/2008

## 12-MONTH ROLLING INCOME RETURN[9]




| As of 12/31/2008 | 1-Year | 5-Year | 10-Year |
|---|---|---|---|
| Fund (w/o sales charge) | -31.06% | -3.24% | 0.93% |
| Fund (with max 4.75% sales charge) | -34.32% | -4.18% | 0.44% |
| Barclays Capital Municipal Bond Index | -2.47% | 2.71% | 4.26% |

Past performance is no guarantee of future results. Investment return and principal value will fluctuate so that shares, when redeemed, may be worth more or less than their original cost. Total return prior to the commencement of Class A Shares reflects the total return of another class, adjusted, where indicated, to reflect applicable sales charges (but not adjusted for other expenses). If adjusted for expenses, the return would be different. Performance is for the stated time period only; due to market volatility, the Fund's current performance may be lower or higher than quoted. For the Fund's performance as of the most recent month end, please refer to www.eatonvance.com. Returns are historical and are calculated by determining the percentage change in NAV with all distributions reinvested. SEC returns reflect maximum front-end sales charge. Returns for other classes of shares offered by the Fund are different. Inception date for National Municipals - A Shares was 4/5/94.

## Not just higher income; higher income with a history of stability

Eaton Vance's active management style, which generally includes purchasing long-maturity bonds and selling shorter-maturity and shorter-call bonds as they age in place or become refunded, has resulted in a more stable dividend over time – something we believe income-oriented muni investors value. As a result of this strategy, our long-maturity funds typically own fewer bonds with shorter effective maturities, which allows us to avoid much of the reinvestment risk associated with having higher-coupon bonds called away during lower interest-rate environments.

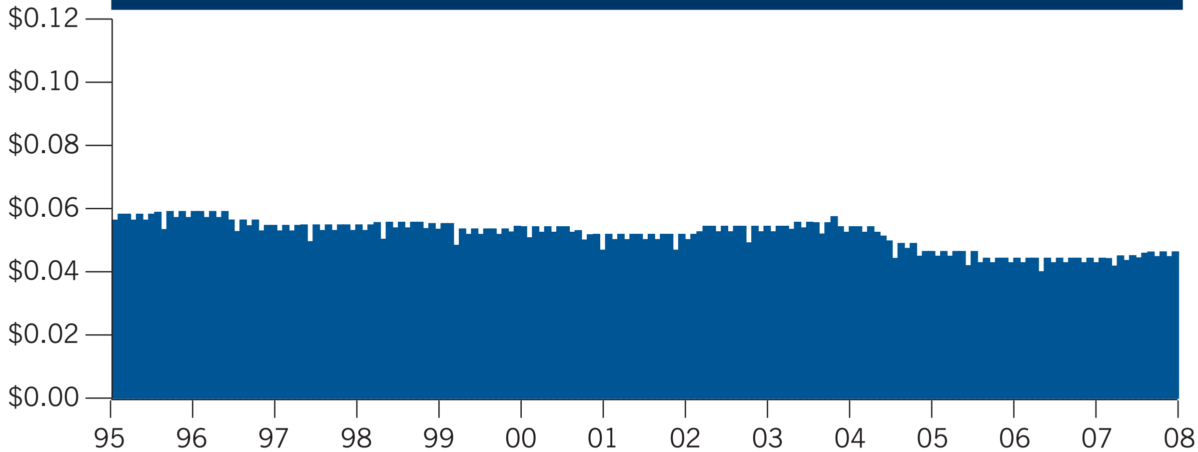
The chart on the next page illustrates the distribution experience for our National Municipals Fund, which, over time, has produced monthly tax-exempt dividends in a relatively tight range.

[9] Source: Lipper / Eaton Vance 12/2008. Barclays Capital Municipal Bond Index is an unmanaged index that is a broad measure of performance of investment-grade municipal bonds with maturities of at least one year. It is not possible to invest directly in an Index.

[10] SEC Yield is calculated by dividing the net investment income per share for the 30-day period by the maximum offering price at the end of the period and annualizing the result.

[11] Source: Prospectus dated 2/1/09. Includes interest expense of 0.46% relating to the Fund's liability with respect to floating rate notes held by third parties in conjunction with inverse floater securities transactions by the Fund. The Fund also records offsetting interest income relating to the municipal obligation underlying such transactions, and as a result net asset value and performance have not been affected by this expense.

## MONTHLY DISTRIBUTIONS – NATIONAL MUNICIPAL FUND (A)[12]

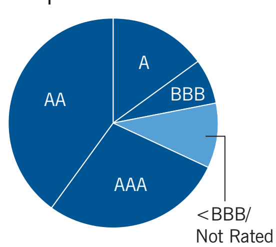



## Best of three worlds: upside potential, higher income with stability AND high quality

At Eaton Vance, our longer-maturity municipal funds provide investors with income returns historically among the highest available; a steady stream of tax-exempt monthly dividends and potential for capital appreciation; and access to high-quality, diversified municipal portfolios. While focused on income, Eaton Vance does not sacrifice quality for yield; the one exception – High Yield Municipals Fund. Our high-yield offering aside, none of our long-maturity national funds holds more than 10% of assets in municipals rated below investment grade (less than BBB).[13] And all four funds are diversified by state, sector, issuer, credit quality and bond type[14] – providing broad access to the municipals market.

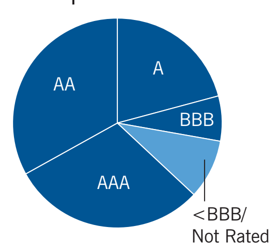
### NATIONAL MUNICIPALS

% ≥ BBB: 90% | # Issues: 309



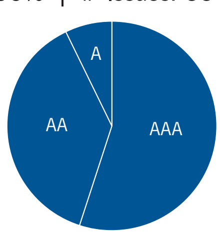

### AMT-FREE MUNICIPAL BOND

% ≥ BBB: 91% | # Issues: 185



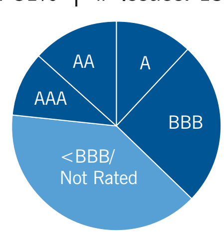

### INSURED MUNICIPALS

% ≥ BBB: 100% | # Issues: 66




### HIGH-YIELD MUNICIPALS

% ≥ BBB: 61% | # Issues: 193




[12] Source: Eaton Vance, 12/2008

[13] As of 12/31/2008

[14] Diversification does not ensure a profit or eliminate risk of loss.

## Discover the long-maturity Eaton Vance municipal funds

| LONG-MATURITY NATIONAL FUNDS (CLASS A SYMBOLS) | | | |
|---|---|---|---|
| **Eaton Vance National Municipals Fund**<br>Our flagship municipal product | EANAX | **Insured Municipals Fund**<br>Our highest-quality municipals fund | EAFIX |
| **Eaton Vance AMT-Free Municipal Bond Fund**<br>Avoid the alternative minimum tax | ETMBX | **High Yield Municipals Fund**<br>Higher risk, higher reward potential | ETHYX |

Performance shown is for Merrill Lynch Municipal Master Index, Merrill Lynch 1-3 Year Municipal Index, Merrill Lynch 3-7 Year Municipal Index, Merrill Lynch 7-12 Year Municipal Index, Merrill Lynch 12-22 Year Municipal Index, and Merrill Lynch 22+ Year Municipal Index.

**ABOUT RISK:** For our national portfolios, a portion of income may be subject to federal income and/or alternative minimum tax. Income may be subject to state and local tax. For our single state portfolios, a portion of income may be subject to federal and state income taxes; a portion of income may be subject to federal alternative minimum tax. Income may be subject to local tax. There is no assurance that the Funds will meet their objectives. Please see a prospectus for an individual Fund's investment policies. Obligations with maturities of 10 years or more may offer higher yields than obligations with short maturities, but they are subject to greater fluctuations in value when interest rates change. The Funds may invest in below-investment-grade obligations, commonly known as "junk bonds," which generally offer higher current yield than higher-rated securities, but are subject to greater risk of price volatility and default. The Funds may engage in derivative transactions that may expose the Funds to increased risk of principal loss. The use of derivatives involves additional risks. The objective and certain policies of the Funds may be changed, by the trustees, without a vote of shareholders. Please see a prospectus for details. Consult a tax/legal advisor before making any tax-related investment decisions.

**Before investing, prospective investors should consider carefully the fund's investment objective, risks, charges, and expenses. The fund's current prospectus contains this and other information about the fund and is available through your financial advisor. Read the prospectus carefully before you invest or send money.**

## Why Eaton Vance?

Eaton Vance is one of the world's most distinguished investment managers, known for offering investors and institutions superior wealth management solutions guided by proven investment principles and deep experience.

Since its founding in 1924, Eaton Vance has held fast to Charles Eaton's belief that "a well-rounded investment management organization is not engaged in a guessing game with other people's money. It is doing a highly specialized professional job, endeavoring to apply knowledge, judgment and decisiveness in action."

This combination of tradition, experience and long-term performance are the enduring values that have helped make Eaton Vance the investment manager of choice for many of today's individual and institutional investors.



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