

WESTERN ASSET MUNICIPAL HIGH INCOME FUND INC.

Form N-CSR

January 08, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM N-CSR**

**CERTIFIED SHAREHOLDER REPORT OF REGISTERED  
MANAGEMENT INVESTMENT COMPANIES**

Investment Company Act file number 811-5497

Western Asset Municipal High Income Fund Inc.  
(Exact name of registrant as specified in charter)

125 Broad Street, New York, NY  
(Address of principal executive offices)

10004  
(Zip code)

Robert I. Frenkel, Esq.  
Legg Mason & Co., LLC  
300 First Stamford Place, 4th Fl.  
Stamford, CT 06902  
(Name and address of agent for service)

Registrant's telephone number, including area code: (800) 451-2010

Date of fiscal year end: October 31,

Date of reporting period: October 31, 2006

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ITEM 1. REPORT TO STOCKHOLDERS.

The Annual Report to Stockholders is filed herewith.

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Western Asset Municipal  
High Income Fund Inc.

**ANNUAL REPORT**

OCTOBER 31, 2006

INVESTMENT PRODUCTS: NOT FDIC INSURED NO BANK GUARANTEE MAY LOSE VALUE

Western Asset Municipal  
Income Fund Inc.

Annual Report October 31, 2006

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Letter from the Chairman

Dear Shareholder,

While the U.S. economy continued to expand, it weakened considerably as the reporting period progressed. After expanding 4.1% in the third quarter of 2005, gross domestic product ( GDP )(i) growth slipped to 1.7% during the last three months of the year. The economy then rebounded sharply in the first quarter of 2006. Over this period, GDP rose 5.6%, its highest reading since the third quarter of 2003. The economy then took a step backwards in the second quarter of 2006, as GDP growth was 2.6% according to the U.S. Commerce Department. The preliminary estimate for third quarter GDP growth was 2.2%.

**R. JAY GERKEN, CFA**

Chairman, President and  
Chief Executive Officer

After increasing the federal funds rate(ii) to 5.25% in June its 17th consecutive rate hike the Federal Reserve Board ( Fed )(iii) paused from raising rates at its next four meetings. In its statement accompanying the December meeting, the Fed stated, Economic growth has slowed over the course of the year, partly reflecting a substantial cooling of the housing market. Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters. The Fed s next meeting is at the end of January, and we believe any further rate movements will likely be data dependent.

Both short- and long- term yields rose over the reporting- period. However, after peaking in late June with two- and 10-year Treasuries hitting 5.29% and 5.25%, respectively rates fell sharply as the Fed paused from its tightening cycle. In addition, inflationary pressures eased as oil prices, which rose to a record \$78 a barrel in mid-July, subsequently fell 15% in the latter part of the third quarter.(iv) Overall, during the 12 months ended October 31, 2006, two-year Treasury yields increased from 4.40% to 4.71%. Over the same period, 10-year Treasury yields moved from 4.57% to 4.61%.

Looking at the municipal market, it outperformed its taxable bond counterparts over the 12 months ended

Western Asset Municipal High Income Fund Inc. I

October 31, 2006. Over that period, the Lehman Brothers Municipal Bond Index(v) and the Lehman Brothers U.S. Aggregate Index(vi), returned 5.75% and 5.19%, respectively.

Please read on for a more detailed look at prevailing economic and market conditions during the Fund's fiscal year and to learn how those conditions have affected Fund performance.

### **Special Shareholder Notices**

Following the purchase of substantially all of Citigroup Inc.'s (Citigroup) asset management business in December 2005, Legg Mason, Inc. (Legg Mason) undertook an internal reorganization to consolidate the advisory services provided to the legacy Citigroup funds through a more limited number of advisers. As part of this reorganization, at a meeting held on June 20, 2006, the Fund's Board approved a new management agreement with Legg Mason Partners Fund Advisor, LLC (LMPFA), under which LMPFA became investment manager for the Fund effective August 1, 2006.

Western Asset Management Company (Western Asset) became subadviser for the Fund, under a new sub-advisory agreement between LMPFA and Western Asset, effective August 1, 2006. LMPFA and Western Asset are wholly-owned subsidiaries of Legg Mason.

The portfolio managers who are responsible for the day-to-day management of the Fund remained the same immediately prior to and immediately after the date of these changes. LMPFA provides administrative and certain oversight services to the Fund. LMPFA has delegated to the subadviser the day-to-day portfolio management of the Fund. The management fee for the Fund remains unchanged.

Prior to October 9, 2006, the Fund was known as Municipal High Income Fund Inc.

### **Information About Your Fund**

As you may be aware, several issues in the mutual fund industry (not directly affecting closed-end investment companies, such as this Fund) have come under the scrutiny of federal and state regulators. Affiliates of the Fund's manager have, in recent years, received requests for information from various

government regulators regarding market timing, late trading, fees, and other mutual fund issues in connection with various investigations. The regulators appear to be examining, among other things, the open-end funds response to market timing and shareholder exchange activity, including compliance with prospectus disclosure related to these subjects. The Fund is not in a position to predict the outcome of these requests and investigations, or whether these may affect the Fund.

Important information with regard to recent regulatory developments that may affect the Fund is contained in the Notes to Financial Statements included in this report.

As always, thank you for your confidence in our stewardship of your assets. We look forward to helping you meet your financial goals.

Sincerely,

R. Jay Gerken, CFA  
Chairman, President and Chief Executive Officer

*December 13, 2006*

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

- (i) Gross domestic product is a market value of goods and services produced by labor and property in a given country.
- (ii) The federal funds rate is the interest rate that banks with excess reserves at a Federal Reserve district bank charge other banks that need overnight loans.
- (iii) The Federal Reserve Board is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
- (iv) Source: *The Wall Street Journal*, 9/29/06.
- (v) The Lehman Brothers Municipal Bond Index is a broad measure of the municipal bond market with maturities of at least one year.
- (vi) The Lehman Brothers U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.

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Fund Overview

**Q. What were the overall market conditions during the Fund's reporting period?**

A. During the reporting period, the bond market faced a number of challenges, including six additional short-term interest rate hikes by the Federal Reserve Board ( Fed )(i), inflationary pressures and a continued economic expansion. However, as the period progressed, oil prices fell sharply, a cooling housing market triggered slower economic growth and the Fed paused from raising rates during its meetings in August, September and October of 2006. All told, the municipal bond market generated positive returns during the one-year period ended October 31, 2006 and outperformed the overall taxable bond market. Over that period, the Lehman Brothers Municipal Bond Index(ii) returned 5.75%, while the Lehman Brothers U.S. Aggregate Index(iii) returned 5.19%.

**Performance Review**

For the 12 months ended October 31, 2006, the Western Asset Municipal High Income Fund Inc. returned 9.24%, based on its net asset value ( NAV )(iv) and 16.66% based on its New York Stock Exchange ( NYSE ) market price per share. In comparison, the Fund's unmanaged benchmark, the Lehman Brothers Municipal Bond Index, returned 5.75% and its Lipper High Yield Municipal Debt Closed-End Funds Category Average(v) increased 10.21% over the same time frame. Please note that Lipper performance returns are based on each fund's NAV.

Certain investors may be subject to the Federal Alternative Minimum Tax, and state and local taxes may apply. Capital gains, if any, are fully taxable. Please consult your personal tax or legal adviser.

During the 12-month period, the Fund made distributions to shareholders totaling 0.408 per share. The performance table shows the Fund's 12-month total return based on its NAV and market price as of October 31, 2006. **Past performance is no guarantee of future results.**

**Performance Snapshot as of October 31, 2006 (unaudited)**

	<b>12-Month Total Return</b>
<b>Price Per Share</b>	
\$8.22 (NAV)	9.24%
\$7.84 (Market Price)	16.66%

**All figures represent past performance and are not a guarantee of future results.**

Total returns are based on changes in NAV or market price, respectively. Total returns assume the reinvestment of all distributions, in additional shares.

**Q. What were the most significant factors affecting Fund performance?**

**What were the leading contributors to performance?**

A. During the period, lower rated municipal bonds outperformed their higher quality counterparts. As a result, the Fund's exposure to high yield, lower quality securities enhanced results. In particular, our security selection in the healthcare sector was beneficial to performance. A number of the Fund's holdings were pre-refunded during the period, also boosting returns. Finally, our defensive posture, which included the use of hedging, aided the Fund's returns.

**What were the leading detractors from performance?**

A. Based on our analysis of the market, we chose not to overweight more speculative areas of the market, such as the airline and tobacco sectors. However, these riskier securities outperformed over the period and our underweight in them served to detract from performance.

**Q. Were there any significant changes to the Fund during the reporting period?**

A. There were no significant changes during the reporting period. While the bond market rallied sharply toward the end of the reporting period, we did not believe it was prudent to adjust the portfolio to a more neutral position. Rather, we maintained a defensive posture and chose not to extend the portfolio's duration(vi). Looking ahead, we will continue to closely monitor the market and economic environment and continue to look for pockets of opportunities in the municipal market.

**Looking for Additional Information?**

The Fund is traded under the symbol *MHF* and its closing market price is available in most newspapers under the NYSE listings. The daily NAV is available on-line under symbol *XMHFX* on most financial websites. *Barron's* and *The Wall Street Journal's* Monday edition both carry closed-end fund tables that provide additional information. In addition, the Fund issues a quarterly press release that can be found on most major financial websites as well as [www.leggmason.com/InvestorServices](http://www.leggmason.com/InvestorServices).

In a continuing effort to provide information concerning the Fund, shareholders may call 1-888-777-0102 Monday through Friday from 8:00 a.m. to 6:00 p.m. Eastern Time, for the Fund's current NAV, market price and other information.

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Thank you for your investment in the Western Asset Municipal High Income Fund Inc. As ever, we appreciate that you have chosen us to manage your assets and we remain focused on achieving the Fund's investment goals.

Sincerely,

Western Asset Management Company

*November 29, 2006*

The information provided is not intended to be a forecast of future events, a guarantee of future results or investment advice. Views expressed may differ from those of the firm as a whole.

The mention of sector breakdowns is for informational purposes only and should not be construed as a recommendation to purchase or sell any securities. The information provided regarding such sectors is not a sufficient basis upon which to make an investment decision. Investors seeking financial advice regarding the appropriateness of investing in any securities or investment strategies discussed should consult their financial professional. Portfolio holdings are subject to change at any time and may not be representative of the Fund's current or future investments. The Fund's top five sector holdings (as a percentage of net assets) as of October 31, 2006 were: Hospitals (19.7%), Pre-Refunded (17.1%), Education (13.2%), Miscellaneous (12.0%) and Transportation (8.3%). The Fund's portfolio composition is subject to change at any time.

**RISKS:** The Fund may use derivatives, such as options and futures, which can be illiquid, may disproportionately increase losses, and have a potentially large impact on Fund performance. High yield bonds involve greater credit and liquidity risks than investment grade bonds. Certain investors may be subject to the Federal Alternative Minimum Tax (AMT), and state and local taxes may apply. Capital gains, if any, are fully taxable.

All index performance reflects no deduction for fees, expenses or taxes. Please note that an investor cannot invest directly in an index.

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- (i) The Federal Reserve Board is responsible for the formulation of a policy designed to promote economic growth, full employment, stable prices, and a sustainable pattern of international trade and payments.
- (ii) The Lehman Brothers Municipal Bond Index is a broad measure of the municipal bond market with maturities of at least one year.
- (iii) The Lehman Brothers U.S. Aggregate Index is a broad-based bond index comprised of government, corporate, mortgage and asset-backed issues, rated investment grade or higher, and having at least one year to maturity.
- (iv) NAV is calculated by subtracting total liabilities and outstanding preferred stock from the closing value of all securities held by the Fund (plus all other assets) and dividing the result (total net assets) by the total number of the common shares outstanding. The NAV fluctuates with changes in the market prices of securities in which the Fund has invested. However, the price at which an investor may buy or sell shares of the Fund is at the Fund's market price as determined by supply of and demand for the Fund's shares.
- (v) Lipper, Inc. is a major independent mutual-fund tracking organization. Returns are based on the 12-month period ended October 31, 2006, including the reinvestment of all distributions, including returns of capital, if any, calculated among the 15 funds in the Fund's Lipper category.
- (vi) Duration is a common gauge of the price sensitivity of a fixed income asset or portfolio to a change in interest rates.

### **Take Advantage of the Fund's Dividend Reinvestment Plan**

As an investor in the Fund, you can participate in its Dividend Reinvestment Plan ( Plan ), a convenient, simple and efficient way to reinvest your dividends and capital gains, if any, in additional shares of the Fund. A more complete description of the Plan begins on page 37. Below is a short summary of how the Plan works.

#### **Plan Summary**

If you are a Plan participant who has not elected to receive your dividends in the form of a cash payment, then your dividend and capital gain distributions will be reinvested automatically in additional shares of the Fund.

The number of shares in the Fund you will receive in lieu of a cash dividend is determined in the following manner. If the market price of the shares is equal to or higher than 98% of the net asset value ( NAV ) per share on the date of valuation, you will be issued shares for the equivalent of either 98% of the most recently determined NAV per share or 95% of the market price, whichever is greater.

If 98% of the NAV per share at the time of valuation is greater than the market price of the common stock, the Fund will buy shares for your account in the open market or on the New York Stock Exchange.

If the Fund begins to purchase additional shares in the open market and the market price of the shares subsequently rises above 98% of the NAV before the purchases are completed, the Fund will attempt to cancel any remaining orders and issue the remaining dividend or distribution in shares at 98% of the Fund's NAV per share. In that case, the number of Fund shares you receive will be based on the weighted average of prices paid for shares purchased in the open market and the price at which the Fund issues the remaining shares.

To find out more detailed information about the Plan and about how you can participate, please call American Stock Transfer & Trust Company at 1 (877) 366-6441.

Fund at a Glance (unaudited)

**Investment Breakdown**

**As a Percent of Total Investments**





## Schedule of Investments (October 31, 2006)

## WESTERN ASSET MUNICIPAL HIGH INCOME FUND INC.

Face Amount	Rating	Security	Value
<b>MUNICIPAL BONDS 97.2%</b>			
<b>Alabama 0.7%</b>			
\$ 615,000	NR	Capstone Improvement District of Brookwood, AL, Series A, 7.700% due 8/15/23 (a)	\$ 135,300
1,000,000	AAA	West Jefferson, AL, Amusement & Public Park Authority Revenue, Visionland Project, Call 12/1/06 @102, 8.000% due 12/1/26 (b)	1,023,340
		<b>Total Alabama</b>	<b>1,158,640</b>
<b>Alaska 1.7%</b>			
1,055,000	NR	Alaska Industrial Development & Export Authority Revenue, Williams Lynxs Alaska Cargoport, 8.125% due 5/1/31 (c)	1,138,187
1,650,000	AAA	Alaska State Housing Financial Corp., General Housing, Series B, MBIA-Insured, 5.250% due 12/1/30	1,782,281
		<b>Total Alaska</b>	<b>2,920,468</b>
<b>Arizona 2.7%</b>			
1,500,000	NR	Casa Grande, AZ, IDA, Hospital Revenue, Casa Grande Regional Medical Center, Series A, 7.625% due 12/1/29	1,673,340
1,760,000	Aaa(d)	Phoenix, AZ, IDA, MFH Revenue, Ventana Palms Apartments Project, Series B, 8.000% due 10/1/34	2,005,432
1,000,000	AAA	Yuma & La Paz Counties, Arizona Community College District, Arizona Western College, FSA-Insured, 5.000% due 7/1/24	1,062,749
		<b>Total Arizona</b>	<b>4,741,521</b>
<b>Arkansas 1.0%</b>			
1,000,000	BBB	Arkansas State Development Financing Authority: Hospital Revenue, Washington Regional Medical Center, Call 2/1/10 @ 100, 7.375% due 2/1/29 (b)	1,113,570
600,000	BB	Industrial Facilities Revenue, Potlatch Corp. Projects, Series A, 7.750% due 8/1/25 (c)	683,556
		<b>Total Arkansas</b>	<b>1,797,126</b>
<b>California 12.3%</b>			
1,500,000	NR	Barona, CA, Band of Mission Indians, GO, 8.250% due 12/1/20 (e)	1,562,445
2,000,000	A3(d)	California Health Facilities Financing Authority Revenue, Refunding, Cedars-Sinai Medical Center, 5.000% due 11/15/27 California State Department of Water Resources & Power Supply Revenue, Series A:	2,094,700

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5,000,000	AAA	MBIA-IBC-Insured, Call 5/1/12 @ 101, 5.375% due 5/1/21 (b)(f)	5,516,800
1,500,000	AAA	XLCA-Insured, Call 5/1/12 @ 101, 5.375% due 5/1/17 (b)	1,655,040
2,500,000	A+	California State, GO, Various Purpose, 5.000% due 9/1/35	2,638,925
1,500,000	NR	California Statewide CDA Revenue, East Valley Tourist Project, Series A, 9.250% due 10/1/20	1,683,180

**See Notes to Financial Statements.**

## Schedule of Investments (October 31, 2006) (continued)

	Face Amount	Rating	Security	Value
<b>California 12.3% (continued)</b>				
\$	2,000,000	BBB	Golden State Tobacco Securitization Corp., California Tobacco Settlement Revenue:	\$ 2,453,820
	1,000,000	AAA	Asset Backed, Series A-4, 7.800% due 6/1/42	
			Enhanced Asset Backed, Series B, Call 6/1/13 @ 100, 5.625%	
			due 6/1/38 (b)	1,117,630
	600,000	BBB+	Redding, CA, Redevelopment Agency Tax Allocation, Shastec Redevelopment Project, 5.000% due 9/1/29	619,572
	1,865,000	Ba2(d)	Vallejo, CA, COP, Touro University, 7.375% due 6/1/29	1,955,937
			<b>Total California</b>	<b>21,298,049</b>
<b>Colorado 3.4%</b>				
	500,000	NR	Beacon Point Metropolitan District, GO, Series A, 6.250% due 12/1/35	532,740
			Colorado Educational & Cultural Facilities Authority Revenue:	
			Charter School:	
	1,230,000	AAA	Bromley School Project, Refunding, XLCA-Insured, 5.125% due 9/15/25	1,326,666
	805,000	AAA	Peak to Peak Project, Call 8/15/11 @ 100, 7.500% due 8/15/21 (b)	920,686
	785,000	NR	Elbert County Charter, 7.375% due 3/1/35	848,632
	1,000,000	AAA	Refunding, University of Denver Project, Series B, FGIC-Insured, 5.250% due 3/1/23	1,108,790
	500,000	NR	High Plains, CO, Metropolitan District, Series A, GO, 6.250% due 12/1/35	536,460
	500,000	NR	Southlands, CO, Metropolitan District Number 1, GO, 7.125% due 12/1/34	551,090
			<b>Total Colorado</b>	<b>5,825,064</b>
<b>District of Columbia 1.2%</b>				
	1,895,000	AAA	District of Columbia COP, District Public Safety & Emergency, AMBAC-Insured, 5.500% due 1/1/20	2,069,132
<b>Florida 11.0%</b>				
	985,000	NR	Beacon Lakes, FL, Community Development District, Special Assessment, Series A, 6.900% due 5/1/35	1,084,258
	1,500,000	NR	Bonnet Creek Resort Community Development District, Special Assessment, 7.500% due 5/1/34	1,656,225
	2,000,000	NR	Capital Projects Finance Authority of Florida, Student Housing Revenue, Capital Projects Loan Program, Florida University, Series A, Call 8/15/10 @ 103, 7.850% due 8/15/31 (b)	2,348,060
	2,000,000	NR	Capital Projects Finance Authority, FL, Continuing Care Retirement Glenridge on Palmer Ranch, Series A, 8.000% due 6/1/32	2,248,300
	950,000	NR	Century Parc Community Development District, Special Assessment,	1,013,660

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1,000,000	A+	7.000% due 11/1/31 Highlands County, FL, Health Facilities Authority Revenue, Adventist Health Systems, Series D, Call 11/15/12 @ 100, 6.000% due 11/15/25 (b)	1,128,520
2,000,000	BB+	Martin County, FL, IDA Revenue, Indiantown Cogeneration Project, Series A, 7.875% due 12/15/25 (c)	2,009,560
1,000,000	NR	Orange County, FL, Health Facilities Authority Revenue, First Mortgage, GF, Orlando Inc. Project, 9.000% due 7/1/31	1,106,820
450,000	AAA	Palm Beach County, FL, Health Facilities Authority Revenue, John F. Kennedy Memorial Hospital Inc. Project, 9.500% due 8/1/13 (g)	542,952

**See Notes to Financial Statements.**

## Schedule of Investments (October 31, 2006) (continued)

	Face Amount	Rating	Security	Value
<b>Florida</b>	<b>11.0% (continued)</b>			
\$	2,000,000	NR	Reunion East Community Development District, Special Assessment, Series A, 7.375% due 5/1/33	\$ 2,222,700
	1,000,000	B-	Santa Rosa, FL, Bay Bridge Authority Revenue, 6.250% due 7/1/28	1,017,280
	1,000,000	AAA	University of Central Florida, COP, Series A, FGIC-Insured, 5.000% due 10/1/25	1,062,740
	1,450,000	NR	Waterlefe, FL, Community Development District, Golf Course Revenue, 8.125% due 10/1/25 (f)	1,475,592
			<b>Total Florida</b>	<b>18,916,667</b>
<b>Georgia</b>	<b>4.1%</b>			
	1,000,000	AAA	Atlanta, GA, Airport Revenue: Series B, FGIC-Insured, 5.625% due 1/1/30 (c)	1,056,870
	1,000,000	AAA	Series G, FSA-Insured, 5.000% due 1/1/26	1,057,570
	2,500,000	NR	Atlanta, GA, Tax Allocation, Atlantic Station Project, 7.900% due 12/1/24 (f)	2,786,200
	1,000,000	A-(h)	Gainesville & Hall County, GA, Development Authority Revenue, Senior Living Facilities, Lanier Village Estates, Series C, 7.250% due 11/15/29	1,092,530
	1,005,000	NR	Walton County, GA, IDA Revenue, Walton Manufacturing Co. Project, 8.500% due 9/1/07	1,016,598
			<b>Total Georgia</b>	<b>7,009,768</b>
<b>Illinois</b>	<b>1.2%</b>			
	2,000,000	AAA	Chicago, IL, GO, Neighborhoods Alive 21 Program, FGIC-Insured, Call 1/1/11 @ 100, 5.500% due 1/1/31 (b)	2,151,140
<b>Indiana</b>	<b>0.5%</b>			
	285,000	NR	County of St Joseph, IN, EDR, Holy Cross Village Notre Dame Project, Series A: 6.000% due 5/15/26	304,357
	550,000	NR	6.000% due 5/15/38	582,681
			<b>Total Indiana</b>	<b>887,038</b>
<b>Kansas</b>	<b>0.7%</b>			
	1,150,000	A-1(d)	Salina, KS, Hospital Revenue, Refunding & Improvement Salina Regional Health, 5.000% due 10/1/22	1,218,114
<b>Louisiana</b>	<b>0.6%</b>			
	1,000,000	NR	Epps, LA, COP, 8.000% due 6/1/18	1,043,310
<b>Maryland</b>	<b>1.6%</b>			
	1,500,000	AAA	Maryland State Economic Development Corp. Revenue, Chesapeake Bay, Series A, Call 12/1/09 @ 101, 7.730% due 12/1/27 (b)	1,692,810
	1,000,000	NR	Maryland State Health & Higher EFA Revenue, Refunding, Edenwald, Series A, 5.400% due 1/1/31	1,039,610

**Total Maryland**

2,732,420

**See Notes to Financial Statements.**

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## Schedule of Investments (October 31, 2006) (continued)

	Face Amount	Rating	Security	Value
<b>Massachusetts</b>	<b>4.0%</b>			
\$	935,000	NR	Boston, MA, Industrial Development Financing Authority Revenue, Roundhouse Hospitality LLC Project, 7.875% due 3/1/25 (c)	\$ 948,791
	1,000,000	NR	Massachusetts State DFA Revenue, Briarwood, Series B, Call 12/1/10 @ 101, 8.250% due 12/1/30 (b)	1,180,160
	1,000,000	BBB	Massachusetts State HEFA Revenue, Caritas Christi Obligation, Series B, 6.750% due 7/1/16	1,127,050
	1,870,000	AAA	Massachusetts State IFA Revenue, Assisted Living Facilities, Marina Bay LLC Project, Call 12/1/07 @ 103, 7.500% due 12/1/27 (b)(c)	1,993,027
	390,000	AAA	Massachusetts State Port Authority Revenue, 13.000% due 7/1/13 (g)	523,123
	1,000,000	AAA	Massachusetts State, School Building Authority, Dedicated Sales Tax Revenue, Series A, FSA-Insured, 5.000% due 8/15/20	1,078,770
			<b>Total Massachusetts</b>	<b>6,850,921</b>
<b>Michigan</b>	<b>5.2%</b>			
	2,130,000	NR	Allen Academy, COP, 7.500% due 6/1/23	2,147,189
	1,000,000	BBB-	Cesar Chavez Academy, COP: 7.250% due 2/1/33	1,062,470
	1,000,000	BBB-	8.000% due 2/1/33	1,142,460
	1,000,000	NR	Gaudior Academy, COP, 7.250% due 4/1/34	1,025,240
	1,750,000	NR	Kalamazoo Advantage Academy, COP, 8.000% due 12/1/33	1,922,288
	1,000,000	NR	Star International Academy, COP, 7.000% due 3/1/33	1,025,190
	700,000	NR	William C. Abney Academy, COP, 6.750% due 7/1/19	701,022
			<b>Total Michigan</b>	<b>9,025,859</b>
<b>Mississippi</b>	<b>0.9%</b>			
	1,480,000	Aaa(d)	Jackson, MS, Public School District, FSA-Insured, 5.000% due 10/1/20	1,585,864
<b>Montana</b>	<b>1.4%</b>			
	2,490,000	NR	Montana State Board of Investment, Resource Recovery Revenue, Yellowstone Energy LP Project, 7.000% due 12/31/19 (c)	2,496,150
<b>New Hampshire</b>	<b>1.0%</b>			
	1,600,000	A	New Hampshire HEFA Revenue, Covenant Health System, 5.500% due 7/1/34	1,707,952
<b>New Jersey</b>	<b>8.7%</b>			
	1,500,000	AAA	Casino Reinvestment Development Authority Revenue, Series A, MBIA-Insured, 5.250% due 6/1/20	1,640,655
	1,000,000	NR	New Jersey EDA, Retirement Community Revenue, SeaBrook Village Inc.,	1,114,710



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5,000,000	NR	Series A, 8.250% due 11/15/30 New Jersey EDA Revenue, Refunding, Series B, 6.875% due 1/1/37 (f)	5,087,650
		New Jersey Health Care Facilities Financing Authority Revenue:	
1,750,000	BBB	Holy Name Hospital, 5.000% due 7/1/36	1,804,005
3,000,000	BBB-	Trinitas Hospital Obligation Group, 7.500% due 7/1/30 (f)	3,320,550
1,750,000	BBB	Tobacco Settlement Financing Corp., 6.750% due 6/1/39	2,002,997
		<b>Total New Jersey</b>	<b>14,970,567</b>

**See Notes to Financial Statements.**

## Schedule of Investments (October 31, 2006) (continued)

	Face Amount	Rating	Security	Value
<b>New Mexico</b>	<b>1.4%</b>			
\$	180,000	AAA	Albuquerque, NM, Hospital Revenue, Southwest Community Health Services, Call 8/1/08 @ 100: 10.000% due 8/1/12 (b)	\$ 197,028
	95,000	AAA	10.125% due 8/1/12 (b)	104,124
	1,000,000	NR	Otero County, NM, Jail Project Revenue, 7.500% due 12/1/24	1,054,920
	1,000,000	A+	Sandoval County, NM, Incentive Payment Revenue, Refunding, 5.000% due 6/1/20	1,064,500
			<b>Total New Mexico</b>	<b>2,420,572</b>
<b>New York</b>	<b>10.4%</b>			
	700,000	NR	Brookhaven, NY, IDA Civic Facilities Revenue, Memorial Hospital Medical Center Inc., Series A, 8.250% due 11/15/30	758,121
	500,000	Aaa(d)	Herkimer County, NY, IDA, Folts Adult Home, Series A, FHA-Insured, GNMA-Collateralized, 5.500% due 3/20/40	555,535
	2,000,000	AAA	Metropolitan Transportation Authority of New York, Series A, AMBAC-Insured, 5.000% due 7/1/30	2,092,060
	1,000,000	NR	Monroe County, NY, IDA, Civic Facilities Revenue, Woodland Village Project, Call 11/15/10 @ 102, 8.550% due 11/15/32 (b)	1,196,150
	1,315,000	NR	New York City, NY, IDA, Civic Facilities Revenue: Community Residence for the Developmentally Disabled Project, 7.500% due 8/1/26	1,356,278
	930,000	NR	Special Needs Facilities Pooled Program, Series A-1, Call 7/1/10 @ 102, 8.125% due 7/1/19 (b)	1,000,689
	1,000,000	AAA	New York City, NY, Municipal Water Finance Authority, Water & Sewer System Revenue, Series C, MBIA-Insured, 5.000% due 6/15/27	1,066,980
	2,090,000	AA+	New York State Dormitory Authority Revenue: Cornell University, Series A, 5.000% due 7/1/21	2,268,215
	1,500,000	AAA	Mental Health Services Facilities Improvement, Series B, AMBAC-Insured, 5.000% due 2/15/35	1,580,985
	1,450,000	AAA	Montefiore Hospital, FGIC/FHA-Insured, 5.000% due 8/1/29	1,534,187
	2,500,000	BB	New York University Hospitals Center, Series A, 5.000% due 7/1/26	2,557,550
	940,000	NR	Suffolk County, NY, IDA, Civic Facilities Revenue, Eastern Long Island Hospital Association, Series A, 7.750% due 1/1/22	1,000,893
	1,000,000	BBB-	Suffolk County, NY, Industrial Development Agency, Continuing Care Retirement Revenue, Refunding, Jeffersons Ferry Project, 5.000% due 11/1/28	1,030,140
			<b>Total New York</b>	<b>17,997,783</b>

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<b>North Carolina</b>	<b>0.6%</b>			
	950,000	NR	North Carolina Medical Care Community, Health Care Facilities Revenue, First Mortgage, DePaul Community Facilities Project, 7.625% due 11/1/29	1,001,082
<b>Ohio</b>	<b>3.6%</b>			
	1,500,000	BBB	Cuyahoga County, OH, Hospital Facilities Revenue, Canton Inc. Project, 7.500% due 1/1/30	1,682,925
	1,500,000	A-	Miami County, OH, Hospital Facilities Revenue, Refunding And Improvement Upper Valley Medical Center, 5.250% due 5/15/21	1,605,615

**See Notes to Financial Statements.**

## Schedule of Investments (October 31, 2006) (continued)

	Face Amount	Rating	Security	Value
<b>Ohio</b>	<b>3.6% (continued)</b>			
\$	60,000	AAA	Montgomery County, OH, Health Systems Revenue, Unrefunded Balance, Series B-1, 8.100% due 7/1/18	\$ 61,378
	1,500,000	BBB-	Ohio State Air Quality Development Authority Revenue, Cleveland Pollution Control, Series A, 6.000% due 12/1/13	1,548,720
	1,260,000	AA+	Riversouth Authority Ohio, Revenue, Riversouth Area Redevelopment, Series A, 5.000% due 12/1/25	1,342,240
			<b>Total Ohio</b>	<b>6,240,878</b>
<b>Pennsylvania</b>	<b>3.9%</b>			
	2,200,000	NR	Allegheny County, PA, IDA, Airport Special Facilities Revenue, USAir, Inc. Project, Series B, 8.500% due 3/1/21 (a)(c)	220
	1,000,000	NR	Cumberland County, PA, Municipal Authority Retirement Community Revenue, Wesley Affiliate Services Inc. Project, Series A, Call 1/1/13 @ 101, 7.250% due 1/1/35 (b)	1,201,890
	1,000,000	BBB	Lebanon County, PA, Health Facilities Authority Revenue, Good Samaritan Hospital Project, 6.000% due 11/15/35	1,087,220
	2,640,000	NR	Montgomery County, PA, Higher Education & Health Authority Revenue, Temple Continuing Care Center, 6.625% due 7/1/19 (a)	132,000
	980,000	NR	Northumberland County, PA, IDA Facilities Revenue, NHS Youth Services Inc. Project, Series A, 7.500% due 2/15/29	1,043,416
	1,000,000	NR	Philadelphia, PA, Authority for IDR, Host Marriot LP Project, Remarketed 10/31/95, 7.750% due 12/1/17	1,001,030
	2,000,000	NR	Westmoreland County, PA, IDA Revenue, Health Care Facilities, Redstone Highlands Health, Series B, Call 11/15/10 @ 101, 8.125% due 11/15/30 (b)	2,339,420
			<b>Total Pennsylvania</b>	<b>6,805,196</b>
<b>South Carolina</b>	<b>0.3%</b>			
	225,000	NR	Florence County, SC, IDR, Stone Container Corp., 7.375% due 2/1/07	226,251
	300,000	NR	McCormick County, SC, COP, 9.750% due 7/1/09	301,041
			<b>Total South Carolina</b>	<b>527,292</b>
<b>Tennessee</b>	<b>2.1%</b>			
	1,000,000	A+	Clarksville, TN, Natural Gas Acquisition Corp. Gas Revenue, 5.000% due 12/15/21	1,094,690
	2,500,000	NR	Shelby County, TN, Health Educational & Housing Facilities Board Revenue, Trezevant Manor Project, Series A, 5.750% due 9/1/37	2,563,925

			<b>Total Tennessee</b>	3,658,615
<b>Texas</b>	<b>8.6%</b>			
	560,000	NR	Bexar County, TX, Housing Financial Corp., MFH Revenue, Continental Lady Ester, Series A, 6.875% due 6/1/29	545,266
	1,000,000	BBB	Garza County Public Facility Corp., 5.500% due 10/1/18	1,057,590
	2,000,000	BBB-	Gulf Coast of Texas, IDA, Solid Waste Disposal Revenue, CITGO Petroleum Corp. Project, 7.500% due 10/1/12 (c)(i)(j)	2,257,280

**See Notes to Financial Statements.**

## Schedule of Investments (October 31, 2006) (continued)

	Face Amount	Rating	Security	Value
<b>Texas 8.6% (continued)</b>				
\$	2,750,000	B-	Houston, TX, Airport Systems Revenue, Special Facilities, Continental Airlines Inc. Project, Series C, 6.125% due 7/15/27 (c)(f)	\$ 2,767,573
	1,000,000	AAA	Laredo, TX, ISD Public Facility Corp. Lease Revenue, Series A, AMBAC-Insured, 5.000% due 8/1/29	1,037,510
	1,000,000	NR	Midlothian, TX, Development Authority, Tax Increment Contract Revenue, 6.200% due 11/15/29	1,022,230
	1,000,000	AAA	North Texas Tollway Authority, Dallas North Tollway Systems Revenue, Series A, FSA-Insured, 5.000% due 1/1/35	1,052,620
	1,000,000	BBB-	Port Corpus Christi, TX, Industrial Development Corp., CITGO Petroleum Corp. Project, 8.250% due 11/1/31 (c)	1,036,290
	1,865,000	NR	West Texas Detention Facility Corp. Revenue, 8.000% due 2/1/25	1,936,989
	1,000,000	NR	Willacy County, TX, PFC Project Revenue: County Jail, 7.500% due 11/1/25	1,028,670
	1,000,000	NR	Series A-1, 8.250% due 12/1/23	1,047,810
			<b>Total Texas</b>	<b>14,789,828</b>
<b>Virginia 1.6%</b>				
	455,000	NR	Alexandria, VA, Redevelopment & Housing Authority, MFH Revenue, Parkwood Court Apartments Project, Series C, 8.125% due 4/1/30	479,361
	1,000,000	NR	Broad Street CDA Revenue, 7.500% due 6/1/33	1,104,380
	1,000,000	BBB	Fairfax County, VA, EDA Revenue, Retirement Community, Greenspring Village, Inc., Series A, Call 10/1/09 @ 102, 7.500% due 10/1/29 (b)	1,124,260
			<b>Total Virginia</b>	<b>2,708,001</b>
<b>Wisconsin 0.8%</b>				
	1,000,000	BBB+	Wisconsin State HEFA Revenue: Aurora Health Care, 6.400% due 4/15/33	1,121,350
	1,745,000	NR	Benchmark Healthcare of Green Bay, Inc. Project, Series A, 7.750% due 5/1/27 (a)	226,850
			<b>Total Wisconsin</b>	<b>1,348,200</b>
			<b>TOTAL INVESTMENTS BEFORE SHORT-TERM INVESTMENTS</b>	
			(Cost \$164,101,534)	<b>167,903,217</b>
<b>SHORT-TERM INVESTMENTS (k) 1.0%</b>				
<b>Illinois 0.3%</b>				
	400,000	A-1+	Illinois Finance Authority Revenue, Northwestern Memorial Hospital, Series B-2, SPA-UBS AG, 3.580%, 11/1/06	400,000
<b>Massachusetts 0.2%</b>				

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	350,000	A-1+	Massachusetts State HEFA, Partners Healthcare Systems, Series D-6, 3.620%, 11/1/06	350,000
<b>New York</b>	<b>0.1%</b>			
	200,000	A-1+	New York City, NY, GO, Subordinated Series H-4, LOC-Bank of New York, 3.550%, 11/1/06	200,000

**See Notes to Financial Statements.**

Schedule of Investments (October 31, 2006) (continued)

Face Amount	Rating	Security	Value
<b>Texas 0.4%</b>			
\$ 300,000	A-1+	Harris County, TX, Health Facilities Development Corp. Revenue: Refunding, Methodist Hospital Systems, Series A, 3.650%, 11/1/06	\$ 300,000
400,000	A-1+	Texas Medical Center Project, Series B, FSA-Insured, SPA-JPMorgan Chase, 3.650%, 11/1/06	400,000
		<b>Total Texas</b>	<b>700,000</b>
		<b>TOTAL SHORT-TERM INVESTMENTS</b> (Cost \$1,650,000)	<b>1,650,000</b>
		<b>TOTAL INVESTMENTS 98.2% Cost \$165,751,534#)</b>	<b>169,553,217</b>
		Other Assets in Excess of Liabilities 1.8%	3,093,854
		<b>TOTAL NET ASSETS 100.0%</b>	<b>\$ 172,647,071</b>

All ratings are by Standard & Poor's Ratings Service, unless otherwise noted. All ratings are unaudited.

- (a) Security is currently in default.
- (b) Pre-Refunded bonds are escrowed with government obligations and/or government agency securities and are considered by the Manager to be triple-A rated even if issuer has not applied for new ratings.
- (c) Income from this issue is considered a preference item for purposes of calculating the alternative minimum tax (AMT).
- (d) Rating by Moody's Investors Service. All ratings are unaudited.
- (e) All or a portion of this security is held at the broker as collateral for open futures contracts.
- (f) All or a portion of this security is segregated for open futures contracts.
- (g) Bonds are escrowed to maturity by government securities and/or U.S. government agency securities and are considered by the Manager to be triple-A rated even if issuer has not applied for new ratings.
- (h) Rating by Fitch Ratings Service. All ratings are unaudited.
- (i) Variable rate security. Interest rate disclosed is that which is in effect at October 31, 2006.
- (j) Maturity date shown represents the mandatory tender date.
- (k) Variable rate demand obligations have a demand feature under which the Fund can tender them back to the issuer on no more than 7 days notice. Date shown is the date of the next interest rate change.

# Aggregate cost for federal income tax purposes is \$165,685,056.



Please see pages 15 and 16 for definitions of ratings.

Abbreviations used in this schedule:

AMBAC	Ambac Assurance Corporation
CDA	Community Development Authority
COP	Certificate of Participation
DFA	Development Finance Agency
EDA	Economic Development Authority
EDR	Economic Development Revenue
EFA	Educational Facilities Authority
FGIC	Financial Guaranty Insurance Company
FHA	Federal Housing Administration
FSA	Financial Security Assurance
GNMA	Government National Mortgage Association
GF	General Facilities
GO	General Obligation
HEFA	Health & Educational Facilities Authority
IBC	Insured Bond Certificates
IDA	Industrial Development Authority
IDR	Industrial Development Revenue
IFA	Industrial Finance Agency
ISD	Independent School District
LOC	Letter of Credit
MBIA	Municipal Bond Investors Assurance Corporation
MFH	Multi Family Housing
PFC	Public Facilities Corporation
SPA	Standby Bond Purchase Agreement
XLCA	XL Capital Assurance Inc.

**See Notes to Financial Statements.**

**Schedule of Investments (October 31, 2006) (continued)**

**Summary of Investments by Industry\***

Hospitals	19.7%
Pre-Refunded	17.1
Education	13.2
Transportation	8.3
Industrial Development	4.8
Life Care Systems	4.0
Public Facilities	3.8
General Obligation	3.5
Housing: Multi-Family	2.8
Cogeneration Facilities	2.7
Pollution Control	2.6
Tobacco	2.6
Tax Allocation	1.0
Utilities	0.7
Water & Sewer	0.6
Escrowed to Maturity	0.6
Miscellaneous	12.0
	100.0%

\* As a percentage of total investments. Please note that Fund holdings are as of October 31, 2006 and are subject to change.

**See Notes to Financial Statements.**

**Bond Ratings (unaudited)**

The definitions of the applicable rating symbols are set forth below:

*Standard & Poor's Ratings Service (Standard & Poor's)* Ratings from AA to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standings within the major rating categories.

- AAA Bonds rated AAA have the highest rating assigned by Standard & Poor's. Capacity to pay interest and repay principal is extremely strong.
- AA Bonds rated AA have a very strong capacity to pay interest and repay principal and differ from the highest rated issues only in a small degree.
- A Bonds rated A have a strong capacity to pay interest and repay principal although they are somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.
- BBB Bonds rated BBB are regarded as having an adequate capacity to pay interest and repay principal. Whereas they normally exhibit adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for bonds in this category than in higher rated categories.
- BB, B, CCC, CC and C Bonds rated BB, B, CCC, CC and C are regarded, on balance, as predominantly speculative with respect to capacity to interest and repay principal in accordance with the terms of the obligation. BB represents the lowest degree of speculation and C the highest degree of speculation. While such bonds will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.
- D Bonds rated D are in default and payment of interest and/or repayment of principal is in arrears.

*Moody's Investors Service (Moody's)* Numerical modifiers 1, 2 and 3 may be applied to each generic rating from Aa to Caa, where 1 is the highest and 3 the lowest ranking within its generic category.

- Aaa Bonds rated Aaa are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as gilt edge. Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.
- Aa Bonds rated Aa are judged to be of high quality by all standards. Together with the Aaa group they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in Aaa securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present which make the long-term risks appear somewhat larger than in Aaa securities.
- A Bonds rated A possess many favorable investment attributes and are to be considered as upper medium grade obligations. Factors giving security to principal and interest are considered adequate but elements may be present which suggest a susceptibility to impairment some time in the future.
- Baa Bonds rated Baa are considered as medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.
- Ba Bonds rated Ba are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate and therefore not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.
- B Bonds rated B generally lack characteristics of desirable investments. Assurance of interest and principal payments or of maintenance of other terms of the contract over any long period of time may be small.



**Bond Ratings (unaudited) (continued)**

- Caa Bonds rated Caa are of poor standing. These may be in default, or present elements of danger may exist with respect to principal or interest.
- Ca Bonds rated Ca represent obligations which are speculative in a high degree. Such issues are often in default or have other marked short-comings.
- C Bonds rated C are the lowest class of bonds and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

*Fitch Ratings Service ( Fitch )* Ratings from AA to CCC may be modified by the addition of a plus (+) or minus (-) sign to show relative standings within the major rating categories.

- AAA Bonds rated AAA have the highest rating assigned by Fitch. Capacity to pay interest and repay principal is extremely strong.
- AA Bonds rated AA have a very strong capacity to pay interest and repay principal and differ from the highest rated issues only in a small degree.
- A Bonds rated A have a strong capacity to pay interest and repay principal although they are somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than debt in higher rated categories.
- BBB Bonds rated BBB are regarded as having an adequate capacity to pay interest and repay principal. Whereas they normally exhibit adequate protection parameters, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity to pay interest and repay principal for bonds in this category than in higher rated categories.
- BB, B, CCC and CC Bonds rated BB , B , CCC and CC are regarded, on balance, as predominantly speculative with respect to capacity to pay interest and repay principal in accordance with the terms of the obligation. BB represents a lower degree of speculation than B , and CC the highest degree of speculation. While such bonds will likely have some quality and protective characteristics, these are outweighed by large uncertainties or major risk exposures to adverse conditions.
- NR Indicates that the bond is not rated by Standard & Poor s, Moody s or Fitch.

**Short-Term Security Ratings (unaudited)**

- SP-1 Standard & Poor s highest rating indicating very strong or strong capacity to pay principal and interest; those issues determined to possess overwhelming safety characteristics are denoted with a plus (+) sign.
- A-1 Standard & Poor s highest commercial paper and variable-rate demand obligation (VRDO) rating indicating that the degree of safety regarding timely payment is either overwhelming or very strong; those issues determined to possess overwhelming safety characteristics are denoted with a plus (+) sign.
- VMIG 1 Moody s highest rating for issues having a demand feature.
- MIG1 Moody s highest rating for short-term municipal obligations.
- P-1 Moody s highest rating for commercial paper and for VRDO prior to the advent of the VMIG 1 rating.
- F-1 Fitch s highest rating indicating the strongest capacity for timely payment of financial commitments; those issues determined to possess overwhelmingly strong credit features are denoted with a plus (+) sign.

**Statement of Assets and Liabilities (October 31, 2006)****ASSETS:**

Investments, at value (Cost \$165,751,534)	\$	169,553,217
Cash		17,748
Interest receivable		3,410,754
Receivable for securities sold		15,000
Prepaid expenses		7,165
<b>Total Assets</b>		<b>173,003,884</b>

**LIABILITIES:**

Payable to broker - variation margin on open futures contracts		138,750
Investment management fee payable		80,393
Accrued expenses		137,670
<b>Total Liabilities</b>		<b>356,813</b>
<b>Total Net Assets</b>	<b>\$</b>	<b>172,647,071</b>

**NET ASSETS:**

Par value (\$0.01 par value; 21,002,201 shares issued and outstanding; 500,000,000 shares authorized)	\$	210,022
Paid-in capital in excess of par value		192,320,568
Undistributed net investment income		409,266
Accumulated net realized loss on investments and futures contracts		(23,859,773)
Net unrealized appreciation on investments and futures contracts		3,566,988
<b>Total Net Assets</b>	<b>\$</b>	<b>172,647,071</b>

**Shares Outstanding**

<b>Net Asset Value</b>	<b>\$</b>	<b>21,002,201</b>
		<b>8.22</b>

**See Notes to Financial Statements.**

**Statement of Operations (For the year ended October 31, 2006)**

<b>INVESTMENT INCOME:</b>		
Interest	\$	<b>10,263,337</b>
<b>EXPENSES:</b>		
Investment management fee (Note 2)		910,681
Legal fees		144,732
Directors' fees		83,313
Transfer agent fees		51,639
Shareholder reports		47,001
Audit and tax		41,524
Administration fees (Note 2)		20,596
Stock exchange listing fees		20,504
Custody fees		7,048
Insurance		3,237
Miscellaneous expenses		12,493
<b>Total Expenses</b>		<b>1,342,768</b>
Less: Fee waivers and/or expense reimbursements (Note 2)		(3,721)
<b>Net Expenses</b>		<b>1,339,047</b>
<b>Net Investment Income</b>		<b>8,924,290</b>
<b>REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS AND FUTURES CONTRACTS (NOTES 1 AND 3):</b>		
Net Realized Gain (Loss) From:		
Investment transactions		(1,416,897)
Futures contracts		3,737,833
<b>Net Realized Gain</b>		<b>2,320,936</b>
Change in Net Unrealized Appreciation/Depreciation From:		
Investments		5,318,614
Futures contracts		(2,264,148)
<b>Change in Net Unrealized Appreciation/Depreciation</b>		<b>3,054,466</b>
<b>Net Gain on Investments and Futures Contracts</b>		<b>5,375,402</b>
<b>Increase in Net Assets From Operations</b>	\$	<b>14,299,692</b>

See Notes to Financial Statements.

**Statements of Changes in Net Assets (For the years ended October 31,)**

	<b>2006</b>		<b>2005</b>
<b>OPERATIONS:</b>			
Net investment income	\$ 8,924,290	\$	9,546,359
Net realized gain (loss)	2,320,936		(9,630,924)
Change in net unrealized appreciation/depreciation	3,054,466		11,740,767
Increase from payment by affiliate (Note 2)			80,000
<b>Increase in Net Assets From Operations</b>	<b>14,299,692</b>		<b>11,736,202</b>
<b>DISTRIBUTIONS TO SHAREHOLDERS FROM (NOTE 1):</b>			
Net investment income	(8,568,898)		(9,429,988)
<b>Decrease in Net Assets From Distributions to Shareholders</b>	<b>(8,568,898)</b>		<b>(9,429,988)</b>
<b>Increase in Net Assets</b>	<b>5,730,794</b>		<b>2,306,214</b>
<b>NET ASSETS:</b>			
Beginning of year	166,916,277		164,610,063
<b>End of year *</b>	<b>\$ 172,647,071</b>	<b>\$</b>	<b>166,916,277</b>
* Includes undistributed net investment income of:	\$ 409,266	\$	67,437

**See Notes to Financial Statements.**



**Financial Highlights**

For a share of capital stock outstanding throughout each year ended October 31:

	<b>2006</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2002</b>
<b>Net Asset Value, Beginning of Year</b>	\$ 7.95	\$ 7.84	\$ 7.92	\$ 8.16	\$ 8.67
<b>Income (Loss) From Operations:</b>					
Net investment income	0.42	0.45	0.51	0.57	0.58
Net realized and unrealized gain (loss)	0.26	0.11	(0.05)	(0.25)	(0.52)
Total Income From Operations	0.68	0.56	0.46	0.32	0.06
<b>Less Distributions From:</b>					
Net investment income	(0.41)	(0.45)	(0.53)	(0.56)	(0.57)
In excess of net investment income			(0.01)		
Total Distributions	(0.41)	(0.45)	(0.54)	(0.56)	(0.57)
<b>Net Asset Value, End of Year</b>	\$ 8.22	\$ 7.95	\$ 7.84	\$ 7.92	\$ 8.16
<b>Market Price, End of Year</b>	\$ 7.84	\$ 7.10	\$ 7.39	\$ 7.65	\$ 7.68
<b>Total Return, Based on NAV(1)(2)</b>	9.24%	7.82%(3)	6.32%	4.42%	0.91%
<b>Total Return, Based on Market Price(2)</b>	16.66%	2.16%	3.76%	7.17%	(4.70)%
<b>Net Assets, End of Year (millions)</b>	\$ 173	\$ 167	\$ 165	\$ 166	\$ 171
<b>Ratios to Average Net Assets:</b>					
Gross expenses	0.79%	0.85%	0.80%	0.80%	0.80%
Net expenses	0.79(4)	0.85	0.80	0.80	0.80
Net investment income	5.27	5.74	6.47	7.13	6.84
<b>Portfolio Turnover Rate</b>	18%	39%	33%	28%	33%

- (1) Performance figures may reflect fee waivers and/or expense reimbursements. Past performance is no guarantee of future results.
- (2) The total return calculation assumes that distributions are reinvested in accordance with the Fund's dividend reinvestment plan. Past performance is no guarantee of future results.
- (3) The investment manager fully reimbursed the Fund for losses incurred resulting from an investment transaction error. Without this reimbursement, total return would not have changed.
- (4) Reflects fee waivers and/or expense reimbursements.

**See Notes to Financial Statements.**

## Notes to Financial Statements

### 1. Organization and Significant Accounting Policies

Western Asset Municipal High Income Fund Inc. (formerly known as Municipal High Income Fund Inc.) (the Fund) was incorporated in Maryland and is registered as a diversified, closed-end management investment company under the Investment Company Act of 1940, as amended (the 1940 Act).

The following are significant accounting policies consistently followed by the Fund and are in conformity with U.S. generally accepted accounting principles (GAAP). Estimates and assumptions are required to be made regarding assets, liabilities and changes in net assets resulting from operations when financial statements are prepared. Changes in the economic environment, financial markets and any other parameters used in determining these estimates could cause actual results to differ.

**(a) Investment Valuation.** Securities are valued at the mean between the bid and asked prices provided by an independent pricing service that are based on transactions in municipal obligations, quotations from municipal bond dealers, market transactions in comparable securities and various other relationships between securities. Securities for which market quotations are not readily available or are determined not to reflect fair value, will be valued in good faith by or under the direction of the Fund's Board of Directors. Short-term obligations with maturities of 60 days or less are valued at amortized cost, which approximates value.

**(b) Financial Futures Contracts.** The Fund may enter into financial futures contracts typically to hedge a portion of the portfolio. Upon entering into a financial futures contract, the Fund is required to deposit cash or securities as initial margin. Additional securities are also segregated up to the current market value of the financial futures contracts. Subsequent payments, known as variation margin, are made or received by the Fund each day, depending on the daily fluctuation in the value of the underlying financial instruments. The Fund recognizes an unrealized gain or loss equal to the daily variation margin. When the financial futures contracts are closed, a realized gain or loss is recognized equal to the difference between the proceeds from (or cost of) the closing transactions and the Fund's basis in the contracts.

The risks associated with entering into financial futures contracts include the possibility that a change in the value of the contract may not correlate with the changes in the value of the underlying instruments. In addition, investing in financial futures contracts involves the risk that the Fund could lose more than the original margin deposit and subsequent payments required for a futures transaction. Risks may also arise upon entering into these contracts from the potential inability of the counterparties to meet the terms of their contracts.

**(c) Security Transactions and Investment Income.** Security transactions are accounted for on a trade date basis. Interest income, adjusted for amortization of premium and accretion of discount, is recorded on the accrual basis. The cost of investments sold is determined by use of the specific identification method. To the extent any issuer defaults on an expected interest payment, the Fund's policy is to generally halt any additional interest income accruals and consider

the realizability of interest accrued up to the date of default.

**Notes to Financial Statements (continued)**

**(d) Credit and Market Risk.** The Fund invests in high yield instruments that are subject to certain credit and market risks. The yields of high yield obligations reflect, among other things, perceived credit and market risks. The Fund's investment in securities rated below investment grade typically involves risks not associated with higher rated securities including, among others, greater risk related to timely and ultimate payment of interest and principal, greater market price volatility and less liquid secondary market trading.

**(e) Distributions to Shareholders.** Distributions from net investment income for the Funds, if any, are declared and paid on a monthly basis. The Fund intends to satisfy conditions that will enable interest from municipal securities, which is exempt from federal and certain state income taxes, to retain such tax-exempt status when distributed to the shareholders of the Fund. Distributions of net realized gains, if any, are taxable and are declared at least annually. Distributions are recorded on the ex-dividend date and are determined in accordance with income tax regulations, which may differ from GAAP.

**(f) Federal and Other Taxes.** It is the Fund's policy to comply with the federal income and excise tax requirements of the Internal Revenue Code of 1986, as amended, applicable to regulated investment companies. Accordingly, the Fund intends to distribute substantially all of its income and net realized gains on investments, if any, to shareholders each year. Therefore, no federal income tax provision is required in the Fund's financial statements.

**(g) Reclassification.** GAAP requires that certain components of net assets be adjusted to reflect permanent differences between financial and tax reporting. These reclassifications have no effect on net assets or net asset values per share. During the current year, the following reclassification has been made:

	<b>Undistributed Net Investment Income</b>	<b>Accumulated Net Realized Loss</b>
(a)	\$ (13,563)	\$ 13,563

(a) Reclassifications are primarily due to differences between book and tax accretion methods for market discount on fixed income securities.

**2. Investment Management Agreement and Other Transactions with Affiliates**

On December 1, 2005, Citigroup Inc. ( Citigroup ) completed the sale of substantially all of its asset management business to Legg Mason, Inc. ( Legg Mason ). As a result, the Fund's then investment manager, Smith Barney Fund Management LLC ( SBFM ), previously an indirect wholly-owned subsidiary of Citigroup, became a wholly-owned subsidiary of Legg Mason. Completion of the sale caused the Fund's then existing investment management and administrative contracts to terminate. The Fund's shareholders approved a new investment management

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contract between the Fund and SBFM, which became effective on December 1, 2005.

Prior to October 1, 2005, the Fund paid SBFM an investment management fee calculated daily and paid monthly at an annual rate of 0.40% of the Fund's average daily net assets and an administration fee calculated at an annual rate of 0.20% of the Fund's average daily net assets.

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**Notes to Financial Statements (continued)**

Effective October 1, 2005, the administration fee payable by the Fund was changed to an annual rate of 0.15% of the Fund's average daily net assets.

Under a new investment management agreement, effective December 1, 2005, the Fund paid an investment management fee calculated daily and paid monthly at an annual rate of 0.55% of the Fund's average daily net assets.

Effective December 1, 2005, as a result of the termination of the administrative contract, the administration fee was no longer applicable.

Effective August 1, 2006, Legg Mason Partners Fund Advisor, LLC ( LMPFA ) became the Fund's investment manager and Western Asset Management Company ( Western Asset ) became the Fund's subadviser. The portfolio managers who are responsible for the day-to-day management of the Fund remain the same immediately prior to and immediately after the date of these changes. LMPFA and Western Asset are wholly-owned subsidiaries of Legg Mason.

LMPFA provides administrative and certain oversight services to the Fund. LMPFA has delegated to the subadviser the day-to-day portfolio management of the Fund. The Fund's investment management fee remains unchanged. For its services, LMPFA pays Western Asset 70% of the net management fee it receives from the Fund.

During the year ended October 31, 2006, the Fund was reimbursed for expenses amounting to \$3,721.

During the year ended October 31, 2005, SBFM reimbursed the Fund in the amount of \$80,000 for losses incurred resulting from an investment transaction error.

Certain officers and one Director of the Fund are employees of Legg Mason or its affiliates and do not receive compensation from the Fund.

**3. Investments**

During the year ended October 31, 2006, the aggregate cost of purchases and proceeds from sales of investments (excluding short-term investments) were as follows:

Purchases	\$ 34,925,776
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Sales 28,262,969

At October 31, 2006, the aggregate gross unrealized appreciation and depreciation of investments for federal income tax purposes were as follows:

Gross unrealized appreciation	\$ 10,386,762
Gross unrealized depreciation	(6,518,601)
Net unrealized appreciation	\$ 3,868,161

At October 31, 2006, the Fund had the following open futures contracts:

<b>Contracts to Sell:</b>	<b>Number of Contracts</b>	<b>Expiration Date</b>	<b>Basis Value</b>	<b>Market Value</b>	<b>Unrealized Loss</b>
U.S. Treasury Bond	185	12/06	\$ 20,606,711	\$ 20,841,406	\$ (234,695)

Notes to Financial Statements (continued)

4. Income Tax Information and Distributions to Shareholders

Subsequent to the fiscal year end, the Fund made the following distributions:

Record Date	Payable Date	Per Share
11/17/06	11/24/06	\$0.0340

The tax character of distributions paid during the fiscal years ended October 31, was as follows:

	2006	2005
Distributions paid from:		
Tax-Exempt Income	\$ 8,568,898	\$ 9,297,683
Ordinary Income		132,305
Total Taxable Distributions		\$ 132,305
Total Distributions Paid	\$ 8,568,898	\$ 9,429,988

As of October 31, 2006, the components of accumulated earnings on a tax basis were as follows:

Undistributed tax-exempt income net	\$ 409,266
Total undistributed earnings	409,266
Capital loss carryforward*	(24,160,946)
Other book/tax temporary differences(a)	234,695
Unrealized appreciation/(depreciation)(b)	3,633,466
Total accumulated earnings/(losses) net	\$ (19,883,519)

\* During the taxable year ended October 31, 2006, the Fund utilized \$60,573 of its capital loss carryover available from prior years. As of October 31, 2006, the Fund had the following net capital loss carryforwards remaining:

Year of Expiration	Amount
10/31/2007	\$ (725,889)
10/31/2008	(747,959)
10/31/2009	(733,106)
10/31/2010	(601,572)
10/31/2011	(5,066,581)
10/31/2012	(10,608,178)
10/31/2013	(5,677,661)
	\$ (24,160,946)



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These amounts will be available to offset any future taxable capital gains.

- (a) Other book/tax temporary differences are attributable primarily to the realization for tax purposes of unrealized losses on certain future contracts.
- (b) The difference between book-basis and tax-basis unrealized appreciation/(depreciation) is attributable primarily to the difference between book & tax accretion methods for market discount on fixed income securities.

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**Notes to Financial Statements (continued)**

**5. Regulatory Matters**

On May 31, 2005, the U.S. Securities and Exchange Commission ( SEC ) issued an order in connection with the settlement of an administrative proceeding against SBFM, the Fund s prior investment manager, and Citigroup Global Markets Inc. ( CGM ) relating to the appointment of an affiliated transfer agent for the Smith Barney family of mutual funds (the Affected Funds ).

The SEC order finds that SBFM and CGM willfully violated Section 206(1) of the Investment Advisers Act of 1940 ( Advisers Act ). Specifically, the order finds that SBFM and CGM knowingly or recklessly failed to disclose to the boards of the Affected Funds in 1999 when proposing a new transfer agent arrangement with an affiliated transfer agent that: First Data Investors Services Group ( First Data ), the Affected Funds then existing transfer agent, had offered to continue as transfer agent and do the same work for substantially less money than before; and that Citigroup Asset Management ( CAM ), the Citigroup business unit that, at the time, included the Affected Funds investment manager and other investment advisory companies, had entered into a side letter with First Data under which CAM agreed to recommend the appointment of First Data as sub-transfer agent to the affiliated transfer agent in exchange for, among other things, a guarantee by First Data of specified amounts of asset management and investment banking fees to CAM and CGM. The order also finds that SBFM and CGM willfully violated Section 206(2) of the Advisers Act by virtue of the omissions discussed above and other misrepresentations and omissions in the materials provided to the Affected Funds boards, including the failure to make clear that the affiliated transfer agent would earn a high profit for performing limited functions while First Data continued to perform almost all of the transfer agent functions, and the suggestion that the proposed arrangement was in the Affected Funds best interests and that no viable alternatives existed. SBFM and CGM do not admit or deny any wrongdoing or liability. The settlement does not establish wrongdoing or liability for purposes of any other proceeding.

The SEC censured SBFM and CGM and ordered them to cease and desist from violations of Sections 206(1) and 206(2) of the Advisers Act. The order requires Citigroup to pay \$208.1 million, including \$109 million in disgorgement of profits, \$19.1 million in interest, and a civil money penalty of \$80 million. Approximately \$24.4 million has already been paid to the Affected Funds, primarily through fee waivers. The remaining \$183.7 million, including the penalty, has been paid to the U.S. Treasury and will be distributed pursuant to a plan submitted for the approval of the SEC. At this time, there is no certainty as to how the above-described proceeds of the settlement will be distributed, to whom such distributions will be made, the methodology by which such distributions will be allocated, and when such distributions will be made.

The order also required that transfer agency fees received from the Affected Funds since December 1, 2004, less certain expenses, be placed in escrow and provided that a portion of such fees might be subsequently distributed in accordance with the terms of the order.

On April 3, 2006, an aggregate amount of approximately \$9 million was distributed to the Affected Funds.

**Notes to Financial Statements (continued)**

The order required SBFM to recommend a new transfer agent contract to the Affected Funds boards within 180 days of the entry of the order; if a Citigroup affiliate submitted a proposal to serve as transfer agent or sub-transfer agent, SBFM and CGM would have been required, at their expense, to engage an independent monitor to oversee a competitive bidding process. On November 21, 2005, and within the specified timeframe, the Affected Funds Board selected a new transfer agent for the Funds. No Citigroup affiliate submitted a proposal to serve as transfer agent. Under the order, SBFM also must comply with an amended version of a vendor policy that Citigroup instituted in August 2004.

Although there can be no assurance, the Fund's manager does not believe that this matter will have a material adverse effect on the Affected Funds.

**This Fund is not among the Affected Funds and therefore did not implement the transfer agent arrangement described above and therefore will not receive any portion of the distributions.**

On December 1, 2005, Citigroup completed the sale of substantially all of its global asset management business, including SBFM, to Legg Mason.

**6. Other Matters**

On September 16, 2005, the staff of the SEC informed SBFM and Salomon Brothers Asset Management Inc. ( SBAM ) that the staff is considering recommending that the SEC institute administrative proceedings against SBFM and SBAM for alleged violations of Sections 19(a) and 34(b) of the 1940 Act (and related Rule 19a-1). The notification is a result of an industry wide inspection undertaken by the SEC and is based upon alleged deficiencies in disclosures regarding dividends and distributions paid to shareholders of certain funds. Section 19(a) and related Rule 19a-1 of the 1940 Act generally require funds that are making dividend and distribution payments to provide shareholders with a written statement disclosing the source of the dividends and distributions, and, in particular, the portion of the payments made from each of net investment income, undistributed net profits and/or paid-in capital. In connection with the contemplated proceedings, the staff may seek a cease and desist order and/or monetary damages from SBFM or SBAM.

Although there can be no assurance, the Fund's manager believes that this matter is not likely to have a material adverse effect on the Fund.

**7. Recent Accounting Pronouncements**

During June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation 48 ( FIN 48 or the Interpretation ), *Accounting for Uncertainty in Income Taxes - an interpretation of FASB statement 109*. FIN 48 supplements FASB Statement 109, Accounting for Income Taxes, by defining the confidence level that a tax position must meet in order to be recognized in the financial statements. FIN 48 prescribes a comprehensive model for how a fund should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the fund has taken or expects to take on a tax return. FIN 48 requires that the tax effects of a position be recognized only if it is more likely than not

to be sustained based solely on its technical merits. Management

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**Notes to Financial Statements (continued)**

must be able to conclude that the tax law, regulations, case law, and other objective information regarding the technical merits sufficiently support the position's sustainability with a likelihood of more than 50 percent. FIN 48 is effective for fiscal periods beginning after December 15, 2006, which for this Fund will be November 1, 2007. At adoption, the financial statements must be adjusted to reflect only those tax positions that are more likely than not to be sustained as of the adoption date. Management of the Fund has determined that adopting FIN 48 will not have a material impact on the Fund's financial statements.

\* \* \*

On September 20, 2006, FASB released Statement of Financial Accounting Standards No. 157 Fair Value Measurements ( FAS 157 ). FAS 157 establishes an authoritative definition of fair value, sets out a framework for measuring fair value, and requires additional disclosures about fair value measurements. The application of FAS 157 is required for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. At this time, management is evaluating the implications of FAS 157 and its impact on the financial statements has not yet been determined.

**Report of Independent Registered Public Accounting Firm**

**The Board of Directors and Shareholders**

**Western Asset Municipal High Income Fund Inc.:**

We have audited the accompanying statement of assets and liabilities, including the schedule of investments, of Western Asset Municipal High Income Fund Inc. (formerly Municipal High Income Fund Inc.), as of October 31, 2006, and the related statement of operations for the year then ended, the statements of changes in net assets for each of the years in the two-year period then ended, and the financial highlights for each of the years in the five-year period then ended. These financial statements and financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of October 31, 2006, by correspondence with the custodian and brokers or by other appropriate auditing procedures. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Western Asset Municipal High Income Fund Inc., as of October 31, 2006, and the results of its operations for the year then ended, the changes in its net assets for each of the years in the two-year period then ended, and the financial highlights for each of the years in the five-year period then ended, in conformity with U.S. generally accepted accounting principles.

New York, New York  
December 27, 2006

**Financial Data (unaudited)**

<b>Record Date</b>	<b>Payable Date</b>	<b>NYSE Closing Price*</b>	<b>Net Asset Value*</b>	<b>Dividend Paid</b>	<b>Dividend Reinvestment Price</b>
<b>Fiscal Year 2005</b>					
11/22/04	11/26/04	\$ 7.30	\$ 7.83	\$ 0.0420	\$ 7.43
12/28/04	12/31/04	7.02	7.88	0.0400	7.17
1/25/06	1/28/05	7.24	7.91	0.0400	7.39
2/22/05	2/25/05	7.24	7.95	0.0400	7.34
3/21/05	3/24/05	7.17	7.95	0.0390	7.16
4/26/05	4/29/05	7.30	7.93	0.0390	7.38
5/24/05	5/27/05	7.34	7.92	0.0390	7.40
6/21/05	6/24/05	7.15	7.89	0.0340	7.24
7/26/05	7/29/05	7.26	7.92	0.0340	7.31
8/23/05	8/26/05	7.25	7.93	0.0340	7.30
9/27/05	9/30/05	7.18	7.93	0.0340	7.30
10/23/05	10/28/05	7.06	7.95	0.0340	7.10
<b>Fiscal Year 2006</b>					
11/21/05	11/25/05	6.96	7.94	0.0340	7.03
12/27/05	12/30/05	7.13	7.98	0.0340	7.16
1/24/06	1/27/06	7.30	8.01	0.0340	7.37
2/21/06	2/24/06	7.32	8.00	0.0340	7.39
3/28/06	3/31/06	7.34	8.02	0.0340	7.38
4/25/06	4/28/06	7.23	8.04	0.0340	7.35
5/23/06	5/26/06	7.30	8.06	0.0340	7.31
6/27/06	6/30/06	7.31	8.03	0.0340	7.29
7/21/06	7/28/06	7.40	8.06	0.0340	7.52
8/18/06	8/25/06	7.45	8.13	0.0340	7.53
9/22/06	9/29/06	7.73			