

January 2002

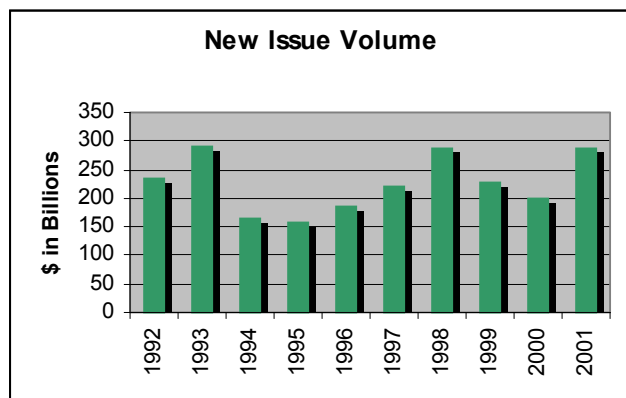
Rising yields

After falling steadily for much of 2001, long and intermediate interest rates turned higher in November. By year end, the 10 year Treasury note was 85 basis points higher than its low on November 7. Investors were reacting to more positive economic reports during the last two months of the year, that the recovery could be closer at hand, and started to sense that the Federal Reserve's easing mode could soon end.

Municipal yields also rose toward year end. Yields were up in sympathy with Treasuries but also due to high new issue volume in the fourth quarter. Municipalities often come to market in the last months of the year, and with rates so low more municipalities were enticed to finance their needs. Yet, in order to entice enough buyers, rates needed to be attractive, and as a result, municipal yields rose more than Treasuries. At year end, 5 year municipal bond yields were 86.4% of 5 year Treasuries and 10 years were 88.2%. At the beginning of September 2001, in comparison, the percentages were 73.7% and 81.7% respectively.

Volume

New issuance in the municipal market was quite robust for all of 2001 as you can see in the adjacent chart of volume over the past ten years. Over \$286 billion in new bonds was issued, slightly more than 1998 and second only to 1993 when \$292 billion was issued. These years show the effect of low interest rate environments where municipalities took advantage of lower rates to either refund old higher coupon debt or brought new issues at the lower more attractive yields.



Adding value

A rise in municipal bond yields creates opportunities for actively managed portfolios. One way to look at this situation is to consider it as great news – reinvestment rates are up, and therefore this is an excellent opportunity to increase portfolio income. A portfolio's value changes as interest rates change, but income only changes when new bonds are bought or old bonds mature or are sold. Since we construct portfolios primarily to capture tax free income, we use the rise in rates as an opportunity to sell lower yielding issues and reinvest the proceeds in higher yielding bonds, thereby increasing portfolio income.

Strategy

Our overall strategy has not changed. With all the uncertainty we continue to look for high quality, undervalued bonds in the intermediate part of the curve. What has changed is that depending on a particular portfolio's structure, we might buy bonds a little longer to capture those higher yields, just as last year, as rates were declining, we were somewhat more cautious and reluctant to extend when interest rates were so low.

Comparative yield curves

The graph below shows 12/31/01 municipal and Treasury yield curves where the municipal curve is grossed up by the new Federal Income tax rate of 38.6%.

