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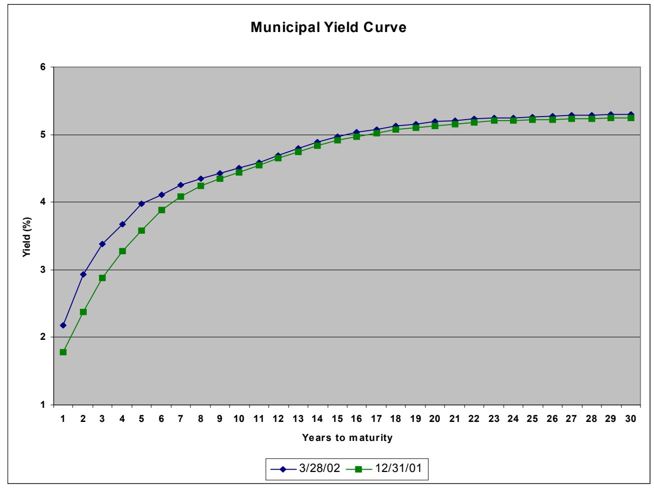
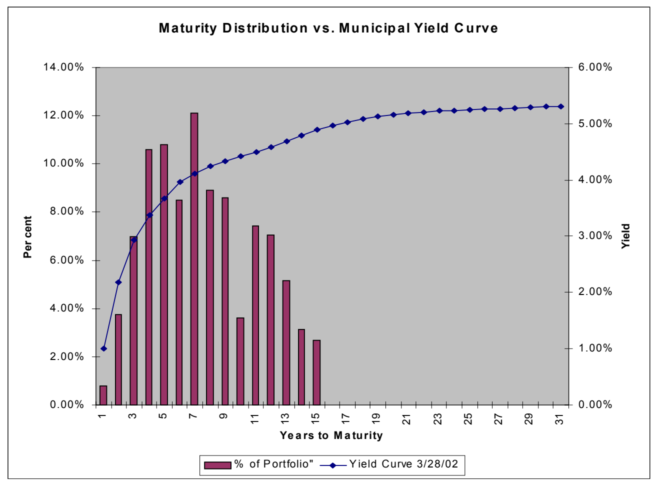
Defensive management

The rise in interest rates over the past two quarters has taught investors an important lesson. While conventional wisdom holds that a bond portfolio's volatility is reduced by shortening maturities, recent experience has again shown that this is not always the case. Longer bonds may have more price volatility for a given change in yields, but rarely do yields change by a constant amount across the entire maturity spectrum. More often, there are far greater changes in short-term yields where shifts in Federal Reserve Board policy have an immediate impact. Such was the case in the first quarter as short-term yields rose while long-term yields remained virtually unchanged, which you can see on the adjacent chart. As a result, an allocation to longer intermediate maturities (10 to 15 years) actually proved more defensive during this period.



Breckinridge continues to structure portfolios to take advantage of the positive slope of the municipal yield curve. As can be seen on the nearby charts, municipal yields increase significantly with the length of time to maturity. The steep pitch of the slope inside 10 years means one can gain much higher yields without venturing too far out the curve. Municipal bonds have historically shown this very positive slope because of a persistent imbalance of supply and demand. Supply is heavily weighted toward longer maturities while demand, which is primarily retail driven, tends to favor short-term bonds.



The lower chart compares the distribution of maturities in a representative portfolio to the 3/28/02 yield curve. The portfolio's structure includes maturities ranging from 1 to 15 years. Bonds longer than 15 years are avoided, as we believe there is incrementally little additional yield for much greater risk. The portfolio's largest exposure is located just beyond the steepest part of the curve, at what is commonly known as the hump of the curve. In addition to offering an attractive risk adjusted return, bonds in this range are also likely to benefit the most from the decline in the market yield experienced over time as they move closer to maturity.

Conclusion

At Breckinridge we manage portfolios to achieve the highest tax-free income with the least amount of risk. Much of this is accomplished by structuring maturities to take advantage of the slope of the yield curve. However, security selection also has a significant role in reducing a portfolio's volatility. Call structure, coupons, sinking funds and credit quality are all-important features we consider. Managing these in the context of the current market helps ensure a more stable portfolio in uncertain times.

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