

## August 2002

Uncertainty about the economy and weakness in the stock market have led to a significant decline in bond yields along with a general deterioration in municipal credit quality. While municipal bonds remain an excellent means of preserving principal and generating tax-free income, we believe these circumstances call for greater caution.

### Interest Rates

The stock market's decline has impacted bond yields on two fronts. First, it has caused investors to shift money away from equities into fixed income driving bond prices higher and yields lower. Second, by creating greater economic uncertainty the decline in stocks has postponed any tightening by the Federal Reserve. Yields are now lower than at the beginning of the year and similar to last fall, with short rates near historic lows. (See adjacent chart).

Given the current interest rate environment, it is critical that a portfolio's structure be balanced with both short and long intermediate maturities. Long intermediate maturities ensure a sustainable income stream should today's low rates persist while short term bonds provide principal stability plus the potential to build income by extending maturities when rates rise.

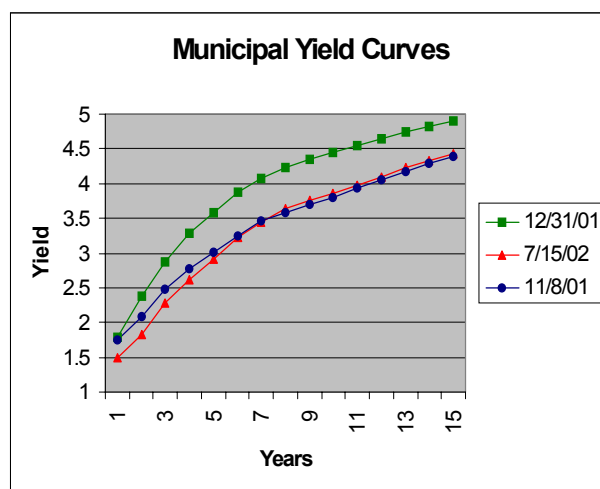
Unfortunately, today's low rates and steep curve make owning short-term bonds costly because of the sizable yield give-up versus longer intermediate bonds. Breckinridge mitigates this cost by using callable premium bonds, which have short durations but significantly better yields. This strategy should also prove more defensive if the yield curve flattens (due to a tightening by the Federal Reserve) as the probability of calls being exercised would then diminish.

### Credit Quality

The recent softness in the economy has once again shown that municipalities are not immune to credit problems. Municipal revenues are highly cyclical and pressure for spending on social services increases as the economy slows. In addition, municipal financial management is often compromised by short-term political considerations. According to the National Governors Association the current economic slowdown is projected to produce state budget shortfalls totaling

\$40 billion in 2002 and 2003, or roughly 8% of revenues. Local governments are suffering as well, especially those that depend heavily on state support.

Steering clear of credit problems requires understanding the nature of the security behind each municipal bond. Breckinridge continues to focus on general obligation or essential service revenue bonds with low to moderate debt burdens. The monopolistic qualities of these issuers make them extremely resilient even in difficult times. We generally avoid bonds of issuers that are more exposed to competitive market forces, such as health care, housing, or project based financing. We also continue to take a very cautious view of bond insurance.



### AMT

Investors may be tempted to buy bonds that are subject to the Alternative Minimum Tax (AMT) as these generally yield an additional 15-20 basis points. Breckinridge does not buy bonds subject to the AMT for a number of reasons. First, we feel the additional yield on AMT is insufficient compensation for the possible increase in our clients' tax liabilities. Second, AMT bonds tend to be issued for "private activity" projects that lack the essential service quality we prefer. Finally, the AMT, developed over 30 years ago, has no inflation adjustment and as incomes have risen, more individuals have become subject to it. Since our goal is to maximize tax-exempt income, bonds that might become taxable to our clients have no place in the portfolios we manage.