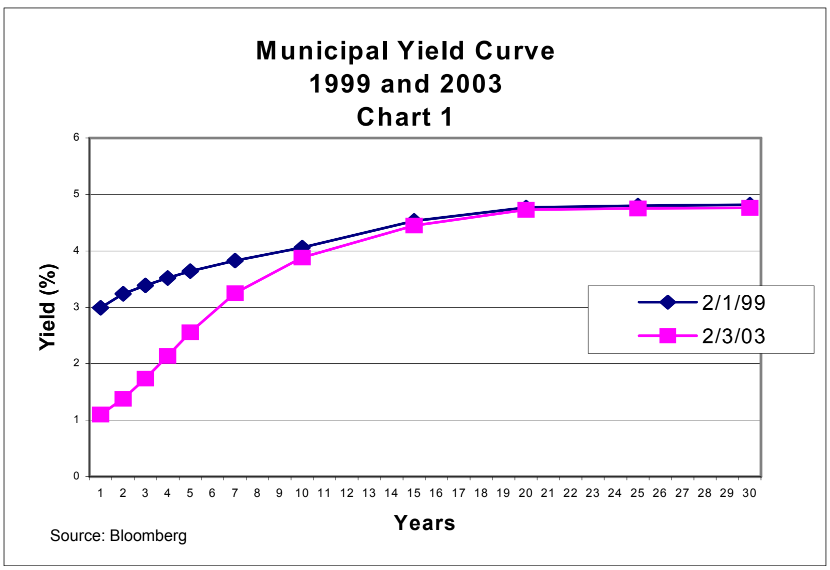
February 2003

Interest rates and the yield curve.

Benign inflation, a soft economy, and a weak stock market have all combined to keep interest rates at historically low levels. The threat of war has contributed as well by causing businesses to defer capital spending and investors to avoid risk. While a turnaround in these conditions may not seem imminent, the economy will eventually improve, the Fed will begin tightening credit and interest rates will then rise. In short, the business cycle will continue. For a well managed municipal bond portfolio, this will present opportunities to increase income. However, investors may be concerned about the short-term impact on the market value of their portfolio. There are several factors we believe should allay this concern.

First, the bond market is not oblivious to the risk curve causes a bond's market yield to decline as it moves closer to maturity over time. For instance, in two years, a 5-year bond will become a 3-year bond. If rates don't change at all, using the current AAA municipal curve, its market yield will decline by about 80 basis points (2.5% to 1.7%). This means it will take an interest rate rise of more than 80 basis points over 2 years for a 5-year bond to experience a decline in market value.

Next, a rise in rates is likely to occur mostly in shorter maturities. Chart #1 offers a useful perspective on the change in municipal bond yields versus four years ago, when interest rates hit their previous low. Yields on municipal bonds beyond 10 years have fallen very little while the Fed's aggressive easing has pushed yields in short-term maturities dramatically lower. When the economy rebounds, Fed action is likely again to have the greatest impact on short-term yields, this time causing them to rise the most, as monetary policy turns restrictive.



of higher rates. In fact, today's yield curve has already factored in a significant rise. The curve's very steep positive slope offers progressively higher yields as maturities are extended. (See Chart #1.) This acts as a buffer against a future rise in rates in two ways. First, the higher yield earned on bonds (versus cash) may offset any loss in market value caused by a rise in rates. Second, the very steep positive slope of today's

Such has been the case through previous interest rate cycles. For this reason, longer intermediate-term bonds of 10-15 years can often help to reduce a portfolio's volatility while at the same time increasing its income.

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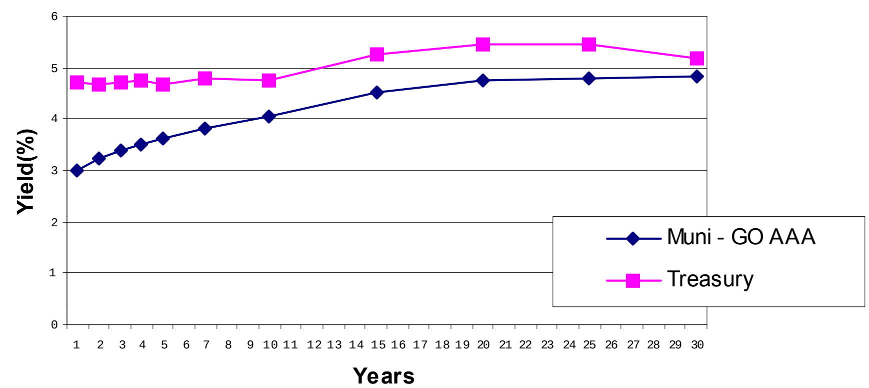
Lastly, municipal bond yields are currently quite high relative to taxable bonds and therefore, should increase less when interest rates begin to rise. Charts #2 and #3, which compare treasury yields to municipal yields, illustrate this view. Chart #2, as of four years ago, reflects a fairly normal relationship between municipal and treasury yields. This is in contrast to municipal yields today (Chart #3), which are now exceptionally high relative to treasuries. The present anomaly probably is the result of a softening in demand for municipals as individual investors have grown more resistant to lower yields. A heavy new issue supply (much of which is driven by lower financing costs) has also put pressure on the municipal bond market. A rise in rates would very likely restore a more normal balance of supply and demand, and thus improve the relative performance of municipals.

In sum, we at Breckinridge believe that the steepness of today's yield curve along with the relative attractiveness of municipal bonds mitigates much of the risk of rise in rates. Moreover, by using defensive strategies in structuring a portfolio's coupons call exposure, and maturities we can reduce volatility and take advantage of higher yields to build income. This approach, together with the security inherent in owning a diverse range of high quality intermediate-term bonds, means the prospect of higher rates can be viewed more as an opportunity than as a risk.

Treasury and Municipal Yield Curve
as of 2/1/99
Chart 2



Treasury and Municipal Yield Curve
as of 2/3/03
Chart 3