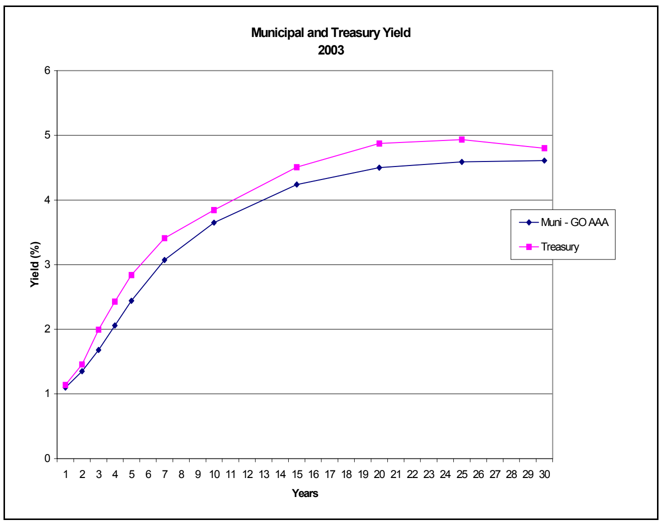
MAY 2003

In the first four months of 2003, municipal yields experienced a modest decline of approximately 10 basis points across the yield curve. This took place despite a slight increase in treasury yields. The stronger performance of municipals reflects their return to a more normal relationship versus treasuries. As noted in our previous newsletter, municipals were extremely undervalued at the start of 2003 - in some instances yielding even more than taxable treasuries. While now lower, municipal yields have lagged the sharp decline in treasury yields over the past several years. At 3.65%, a AAA rated 10-year municipal bond today yields about 95% of the 10-year treasury bond, which is well above historical averages. In fact, municipal spreads remain advantageous across the entire treasury curve (see Chart).



Not Immune from Turbulence

It is not uncommon for municipal yields to trail a significant move up or down in interest rates; the market's retail base tends to be less responsive than the institutional buyers that dominate other fixed income markets. Despite this lag, recent experience has shown that the municipal market is not immune to short-term volatility. In March of this year, municipal yields spiked almost 50 basis points higher in the span of just over a week, resulting in an abrupt reduction in municipal bond prices. This sell-off was not unlike that of October 2002 or November of 2001 when municipal yields vaulted almost 70 basis points in less than month.

New Realities Contribute To Volatility

Recent history suggests that volatility in the fixed income markets is occurring with greater frequency than it used to. In part, this is because bond investors trade more actively now than they did in the past. In addition, leverage is more prevalent as hedge fund and derivatives players make larger bets on interest rates and yield curves. The growth of the mortgage-backed securities market has also been a significant contributing factor. Mortgage-backed portfolios must be constantly adjusted to counter changes in mortgage prepayment assumptions. As a result, their managers are often forced to sell into market weakness or buy into strength, which adds to bond market volatility.

In the municipal market when derivatives and leverage strategies create selling pressure, the market can fall sharply. This is because municipal demand is still primarily driven by the retail sector, which is slow to absorb excess supply. At the same time, dealers will resist adding to their inventory due to the difficulty in hedging municipal bond positions. Thus prices must be cut to boost yields and attract new buyers – often institutions such as endowments and pension funds that don't even benefit from the tax-exemption of municipal income.

Separate Accounts Provide Stability and Opportunity

While market turbulence is a source of concern for many already shaken investors, it need not be. Volatility due to a short-term sell-off, unrelated to inflation or credit quality, poses no long-term threat to high-grade intermediate municipal portfolios. Moreover, investors with separately managed accounts can weather such periods because they own their bonds directly, are not dependent upon the market, and can count on coupons and principal payments from high quality intermediate bonds to provide a reliable source of income and capital. Volatility can produce painful declines in a bond portfolio's market value, but it is usually temporary. AND if properly structured, an actively managed portfolio can take advantage of an over-sold market to extend maturities and lock-in higher yields to build its income stream. For investors who want both a reliable source of tax-free income and preservation of principal, municipal bonds still represent a sound investment.

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