BCA BRECKINRIDGE CAPITAL ADVISORS

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After declining for much of 2003, interest rates turned sharply higher in June. The 10-year Treasury bond now yields about 4.6%, up from 3.87 % at the start of the year and 3.11% at its low point in mid-June. This recent volatility has unsettled some investors, but as highlighted in our previous newsletter, there are "new realities" in the bond market which contribute to larger, more frequent interest rate swings.

It's important to note that the interest rate decline in recent years has been driven largely by declining inflation. While nominal interest rates hit 45-year lows, the fall in *real* interest rates on bonds (nominal rates minus expected inflation) was far less dramatic. In May, the Federal Reserve's comments highlighting a potential threat of deflation may have temporarily lowered the market's inflation expectations and, thus, nominal rates. Since then, however, signs of an improving economy have significantly shifted investor sentiment.

Should Municipal Bond Investors Follow the Herd?

While Breckinridge does not make asset allocation recommendations, we firmly believe municipal bond investors should not practice interest rate timing by selling or trimming their portfolios. Experience suggests a more prudent and productive strategy employs a diversified portfolio with a relatively neutral interest-rate structure. Breckinridge portfolios typically hold premium coupon bonds within a range of short and intermediate maturities creating an average portfolio duration of four to five years. Such a portfolio doesn't imply risky interest rate bets; rather, if interest rates rise (and bond prices fall) the shorter-term bonds are less price sensitive and can be used to swap into higher, more attractive yields. Should rates fall, longer-term intermediate maturity bonds help ensure a sustainable income stream.

Advantages of Separate Accounts

Market disruptions can be unsettling. However, as we've noted before, short-term price fluctuations unrelated to inflation or credit should pose little threat to high-grade, intermediate municipal portfolios. Unlike investors owning mutual funds, investors holding separately managed accounts own bonds directly and thus are insulated from market gyrations since on any given day they can know their income stream and capital level with certainty. Furthermore, volatility presents an opportunity for actively managed accounts – as rates rise and the market gets sloppy, inefficiencies abound. By exploiting inefficiencies in execution and security selection, and by reinvesting maturing bonds at higher rates, we can and boost income to create long-term value in our client portfolios.

Does Credit Risk Matter?

While fluctuating interest rates have dominated the investment environment recently, credit risk plays a key role in municipal bond valuation. We try to mitigate credit risk in our portfolios by thoughtful security selection among "A" rated or better G.O. and revenue bonds, without relying on bond insurance. However, many states are grappling with the fall-out from weak economies and are facing reduced revenue streams and budget shortfalls. We believe the likelihood of any state defaulting on its general obligation debt is slim, particularly when one considers that no state has defaulted since 1840. The relative safety of these investments over the past 160 years doesn't derive from astute governance or from municipalities' immunity to economic cycles; rather, safety lies in the perpetuation of the country's states, cities and towns and in the monopolistic quality of the essential services provided. In fact, Moody's Investors published a "State of the States" report in July noting that despite fiscal pressures, wealth indicators and per capita debt levels nationwide were in line with historical norms.

What About California?

California has been leading the news recently, including headlining Newsweek's July 28th issue "California in Crisis". Furthermore, Standard and Poor's recently downgraded California's G.O. rating from A to BBB in the face of the state's well-publicized political and financial problems. However, California has ample financial resources, and per capital debt levels remain manageable, both credit factors that we watch closely. We would note that historically municipalities under stress – including New York City in the 1970s and Philadelphia, Washington D.C. and Orange County in the 1990s – have ultimately worked through their problems, often through external financial control boards, and have offered tremendous opportunities for astute investors. We plan to monitor the state's bonds with an eye to a favorable time to realize potentially attractive returns.

Where Are We Going From Here?

Despite rising interest rates and sloppy markets, the defensive nature of municipal bonds resulted in fewer losses than those experienced by U.S. government and mortgage-backed securities. In fact, the higher yields available today are enticing retail municipal buyers that have stayed on the sidelines throughout the past months. The improvement in retail demand sends a strong signal that the municipal market sector is successfully attracting capital at current levels and that municipal bonds continue to offer a reliable tax-free income stream and safety of principal.