

January 2004

The municipal market in 2003 saw record new issue volume of \$383 billion and some hints at the volatility that is forecast as the economy recovers. In July, the fixed income market sensed economic growth and potential inflation for the first time in two years. The market reacted by driving up 10-year municipal yields 122 basis points over a 62-day span. The inflation threat was quickly discounted and the yields ended the year 10-15 basis points lower than when the year began. Patient investment through this cycle helped Breckinridge's Composite Return move ahead of the benchmark indexes for the year.

We enter 2004 with market consensus that yields will rise over the next twelve months. One survey of institutional municipal managers showed a complete consensus of positioning for higher rates. In December and January, we have focused on buying longer-term investments because institutional portfolios were too short. From January 2, 2004, through January 14, 2004, 10-year municipal bond yields fell by 28 basis points. Now, we are beginning to position portfolios slightly more defensively to take advantage of an emerging "overbought" market. We are focusing on keeping portfolio risk slightly lower than the benchmark indexes. Since the municipal market is less efficient than the government markets, we are beginning the investment change ahead of the market move.

We believe the market will continue to rally mildly through the US Treasury refunding in February. A weakening dollar may have a cushioning impact on yields as foreign governments purchase US securities to bolster the dollar and protect their currency from rising too quickly. The Federal Reserve appears settled on a policy of stable short-term rates for the foreseeable future. They are less worried about inflation than possible deflation. Municipal bonds yields have fallen as a ratio to Treasuries over the last few months. A stable taxable market should limit any rise in municipal yields. A large portion of the municipal supply in 2003 was placed with closed-end leveraged municipal funds. We believe that these investors will hold positions until short-term rates begin to rise. At that point, long-term yields may rise substantially, as the positions are unwound. Interest rates are likely to rise most sharply in the relatively flat area of the yield curve beyond 15 years where leveraged investments are concentrated. However, we anticipate a flatter yield curve for bonds shorter than 10 years and are positioning portfolios for this change.

Analysis of Alternative Minimum Tax

There are a number of tax law changes taking effect over the next six years that will cause a rise in taxpayers paying the Alternative Minimum Tax (AMT). It is anticipated AMT taxpayers will rise from 1 million in 1999 to 33 million by 2010. The tax was not indexed for inflation and the minimum income for calculation of AMT was unchanged at \$45,000 from 1993 to 2000. Under the new tax act the minimum income for AMT rose to \$58,000 for 2003 and 2004.

The highest marginal tax rates through 2004 is 35% and the marginal rate for married filing jointly returns at \$100,000 in income is only 25%. With an AMT of 28% on income over \$58,000, it is clear from the relative marginal rates that most taxpayers with incomes at or above \$200,000 will be at growing risk of the AMT.

Municipal bond interest from nonessential revenue bonds is included in taxable income for AMT taxpayers. Breckinridge has a firm policy of purchasing no AMT municipal bonds. We believe that although these bonds pay a slightly higher yield, the risk of more taxpayers paying the AMT will cause these bonds to be traded at taxable bond spreads. We believe the spread on these bonds will increase substantially through the rest of the decade.

Sharp Drop in New Municipal Issuance after Year-end

