

July 2004

In July, the municipal market drifted higher as the June economic reports were less robust than expected. The yield curve behaved well for our barbell trade, with 10-15 year yields falling 16-18 basis points, five year bullet yields falling 12 basis points and 1-2 year yields falling 13 basis points. The Federal Open Market Committee (FOMC) meets on August 10 and most economists are predicting another 25 basis points rise in the Fed Funds rate. This will help raise the reinvestment yields of maturing bonds.

Some clients may notice that we are taking more time in investing cash over the last month. July 1 is traditionally the largest redemption of municipal bonds each year. The yields available for the one- and two-year municipals are very rich compared to taxable yields. This is a seasonal effect and we have held off on pursuing this paper until the supply and demand effect of the redemptions passes. We expect this to take place over August and September. If the municipals remain too rich, we may move some cash temporarily into 3-month T-Bills and swap into short municipal paper when it becomes more attractive.

We are maintaining our strategy of barbelled maturities and short-neutral duration in portfolios. This strategy is designed to take advantage of rising short-term rates with higher reinvestment through 2006 and high 10-year maturity yields. Over the next two years, the portfolios will be reinvested for a more balanced approach as the longer bonds roll down the yield curve.

Trading in an inefficient market.

Active municipal bond management offers a wide range of potential advantages such as through security selection, portfolio structuring, and credit research. Because of the recent regulatory action against a number of municipal dealers for abusive mark-ups, we thought it timely to emphasize the advantage offered by better trading. Abusive mark-ups are possible in the municipal market because it is a fragmented and inefficient market with limited price discovery. Consequently, there are significant pricing disparities - meaning bonds often trade significantly above or below fair value. Investors and/or their brokers with limited market access and trading expertise are often ill-equipped to recognize these disparities and thus, are vulnerable to abusive mark-ups. On the other hand, an astute municipal trader can exploit these inefficiencies to improve a portfolio's tax exempt income.

The chart below is a comparison of the Breckinridge trading activity and market trading activity as reported by the Municipal Securities Rulemaking Board. The comparison is the yield-to-maturity spread to Municipal Market Data's AAA-yield for 10 and 11 year maturities. The MSRB data represents the subset of 30,000 premium essential service and general obligation bonds sold by brokers to customers (both individual and institutional) from May 13 to July 30, 2004. The Breckinridge trades are all 10 to 11 year purchases for client portfolios over the same period.

The first thing to notice is the disparity in the spreads from the MSRB. The bonds included in the sample traded at spreads of -50 basis points to +50 basis points to maturity from the AAA-curve. The average spread was +3 basis points. The higher the spread the cheaper the bond is priced. The trades include Breckinridge and other institutional buyers as well as individual investors. Spreads tend to be lower for small trades, indicating that these are individual investor purchases.

The Breckinridge purchases had spreads that ranged from +3 basis points to +52 basis points. The average spread was +25 basis points. The 22 basis point higher average represents a savings of about \$17.30 per \$1000 in creating a portfolio. Obviously, if an investor's trading/execution is below average the savings Breckinridge offers could be considerably higher.

Comparison of Breckinridge Trades and MSRB Trades

