

September 2004

During September, municipal bond portfolios collected their coupons. The only change in the yield curve was a slight flattening with higher short-term rates. The ongoing economic story is whether oil prices will remain high long enough to cut off economic growth in a meaningful way. If this happens, the Federal Reserve policy estimates may change to a lower final target in the current cycle. Thus far, this chain of possible events has caused bond prices to be highly correlated to oil prices.

We changed our strategy slightly in early September. Our target duration was shortened another ¼ year to the low end of our range. We saw a tepid rally in bonds that failed to show sufficient volume or follow through. Our trading concentrated on filling short maturity and cash needs while we avoided heavy commitments to longer maturity issues. Toward the end of the month, we found some opportunities to extend maturity as new issues came to market. Overall, we remain in a slightly shorter duration maturity barbell.

Breckinridge Swap Activity

Breckinridge’s focus on fixed income and particularly municipal portfolios creates situations for us to take advantage of the market conditions. Sometimes the market offers valuable opportunities to refine portfolio holdings to fit our current outlook and strategy. Oftentimes we can reposition portfolios to improve investment value, increase income or improve portfolio structure.

Lengthening Swaps

Breckinridge invests to produce tax-advantaged income and to protect principal value. There are times when a portfolio ages or the market changes and the holdings do not represent these goals. We actively review accounts to be sure that the holdings are appropriate. An account that becomes too short creates reinvestment risk. Selling a short maturity issue and reinvesting in longer bonds will increase the yield of the portfolio. This year, the yield increase between one-year and ten-year maturity bonds has averaged 238 b.p., with a maximum spread of 278 b.p. in May. With an average one-year yield of 1.28% so far this year, the higher income flow adds to the investor’s after-tax return. Over the last 23 years, income represented 83% of the total return of 5-year AAA-rated municipal bonds.

Swapping Out of Callable Bonds

Since the market peak in March, 2004, we have looked to move portfolios into non-call bonds. The market tends to value callable bonds to either the call date, if most

traders anticipate the call being exercised, or maturity, if most traders believe the bond will not be called. In cases where the difference between the call date and maturity exceed four years, the price risk of holding the bond is exacerbated by the change in market perception of the likelihood of the call being exercised as yields rise. We have been actively selling these bonds when we can get bids to the call and replacing them with non-call or better call protected issues. These trades tend to increase yield and reduce the market volatility of the portfolio.

Maturity Barbell Swaps

Throughout the year, we have tried to reposition portfolios to take advantage of the steep yield curve. At the beginning of the year, the yield curve was historically steep. When a tax-efficient trade was available, we sold four to seven year maturity bonds and purchased a combination of short and longer maturity bonds. We concentrated our long purchases in ten-year maturity bonds. This prepared the portfolio for a two-year cycle of flattening yield curves driven by increased Fed Funds rates on the short end and attractive yields on the longer bonds. Over the next two years, we will see the ten-year bonds roll down the yield curve to eight year maturities and at the same time we will be increasing the portfolio yield through reinvestment of the short-term investments. So far this year, the yield curve is significantly flatter with short-term yields rising and ten-year yields remaining fairly stable for the year-to-date.

One of the biggest benefits of an actively managed separate account is the specialized review of your portfolio to meet your needs. These swaps are a vital piece of achieving our goal of the highest after-tax income with minimal capital risk.

