

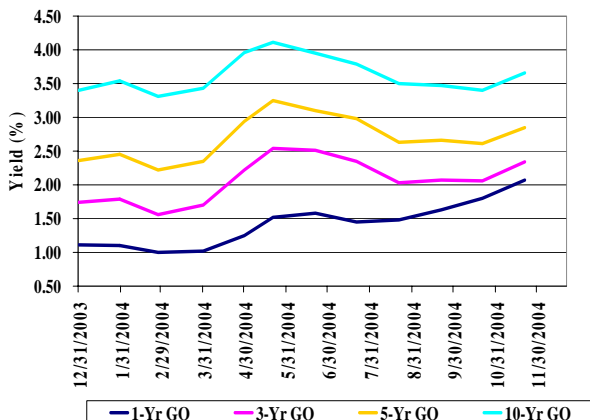
November 2004

In November, the Federal Reserve moved the target for fed funds to 2%, doubling the rate over the last six months. The 25 basis point increase was reflected in municipal yields from one to fifteen years as the yield moved in a nearly parallel shift upward. In early November, the report of strong employment growth confirmed that the economy was still growing and helped push yields higher on longer maturity issues. The month ended anticipating another strong employment report for November and another fed funds increase at the December 14 meeting of the FOMC. Although the November report was weaker than expected, the yield curve should continue to trend flatter as short term rates rise in response to Fed tightening and moderate economic growth limiting inflation fears.

One change in market psychology that is notable is that the linkage of market performance to oil prices seems to have unraveled. As noted last month, the ten-year yields were very highly correlated to oil prices. Now, since oil prices have begun to fall as inventories appear to be replenished, both fixed income and equity traders have begun to look at more fundamental economic indicators for direction.

We continue to look for a drift to higher interest rates over the next six months as fed funds targets rise to the 3-3.5% range. We expect the yield curve to continue its pattern of flattening with higher yields in short-term maturities and relative stability in the 10-year area (see Chart below). As this occurs, we will be watching the relative value of the five to seven year bonds for signs the intermediate area of the curve may be approaching a more stable slope. Portfolios can then be rebalanced with the proceeds of the short-term bonds we are currently overweighing with our barbell strategy.

**Municipal Yields
Monthly - 2004**



Investment Goals and Benchmark Indices

When investors allocate a portion of their portfolio to municipal bonds, it is generally for a low volatility safe harbor to generate tax-advantaged income. In most cases the investor is more concerned with absolute return than a total return comparison to an index. So the portfolio serves two purposes: high after-tax income and stable asset values. Although the overall investment goal is generally consistent investor to investor, the amount of risk and income needs of investors can vary widely.

At Breckinridge, we use indices to provide risk tolerance/income guidelines of our clients. An index is useful for discussing the market risks and relative returns of differing strategies, but we do not manage portfolios to replicate index returns because each investor’s needs are different.

As a guideline, the most risk-averse investors choose a Short-Term index with a one to three year maturity. The type of portfolio is managed to minimize the risk of losses of asset value over short holding periods. As an extremely safe investment, the average yield of the index is 2.35%.

Almost 80% of Breckinridge clients choose an Intermediate index. A sample of an intermediate index is the Merrill Lynch 3-7 year Municipal Bond Index. Although this index has more price volatility than a short-term index, the average yield of the index is currently 3.06%. Since most investors are making a longer-term allocation to municipal bonds, the short-term price volatility is acceptable to gain a better yield.

Some investors have a higher risk tolerance and prefer a Long-Intermediate index like the Merrill Lynch 1-12 Year Municipal Bond Index. This index has much higher price volatility, so the risk of losses is higher over short holding periods. The benefit of this strategy is a higher average index yield of 3.42%. This strategy fits investors with a long investment horizon or who have other diversified assets.

In addition to maturity risk tolerance and return, portfolios need to be built around an investor’s tax situation and credit risk preferences. These preferences will affect the returns on the portfolio but will better meet the investment goals of the portfolio. The most common tax limits are state and local income taxes and federal alternative minimum tax limitations. By individually building portfolios, Breckinridge can increase the tax-advantaged income with out increasing risk.