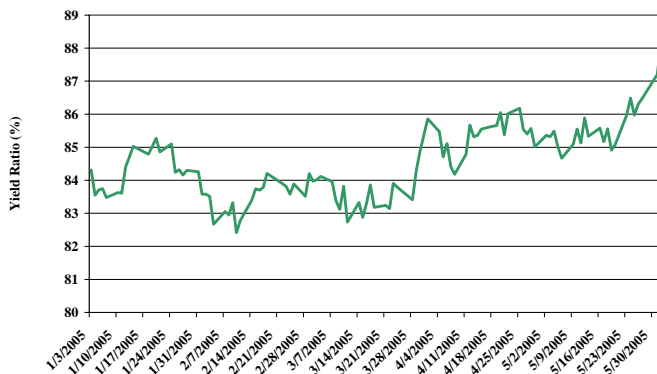


May 2005

In May, municipal yields followed the Treasury market to new lows for the year. The mixed signals coming from the members of the Fed Board led many street analysts to reduce their year-end estimate of the 10-year Treasury from 5% to less than 4%. The dollar is higher as France and the Netherlands rejected the Euro Constitution and foreign investment has remained a source of demand for US securities. As is often the case, municipal yields lagged the Treasury market in a sharp move lower. The yield ratio to Treasuries in the 10-year maturity rose from 83% to 88% over the last two months. This makes tax-exempt bonds more attractive to most taxable investors.

AAA GOs 10-yr / Treasury 10-yr



Source: Thomson Financial Municipal Market Data, 2005

We have continued to move to a more bulleted portfolio structure as the yield curve has become very flat. The spread between one-year and ten-year municipals has dropped from 1.74% to 0.73% so far this year. We are actively filling in maturities we were avoiding through the flattening as we become more neutral on the direction of the yield curve.

During May we began to move to a more neutral duration to portfolio benchmarks. As our Outlook has pointed out for the last year, we anticipated that 10-year municipals would hold their value as the yield curve flattened. This has been the case with 10-year AAA municipal yields remaining in a tight trading range of 3.36% to 3.85% from July 2004 to June 2005. We are using proceeds from maturities to extend portfolios into the belly of the curve.

Our more neutral position reflects the view that yields may drop further if the economy continues to slow as indicated by leading indicators and manufacturing surveys. However we remain in a conservative maturity structure. Yields may rise if inflation grows at the pace we saw earlier in the year. So we believe the most prudent portfolio strategy is to lock in yields as we find trades that represent the best value in the market and not make duration bets at this time.

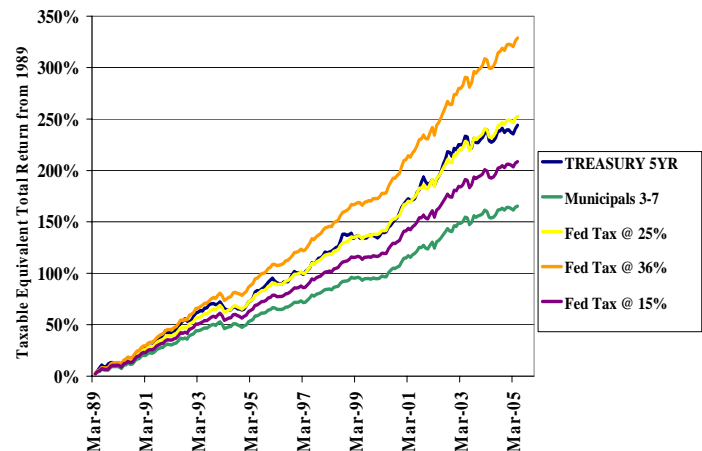
Municipal Bond Fixed Income Allocation

With many investors moving into the Alternative Minimum Tax, the question has arisen when to reallocate to taxable bonds. Using the Merrill Lynch Indices, we compared the total cumulative return for a 5 yr Treasury Index¹ to the 5 yr Municipal Index² on a taxable equivalent basis for various tax rates.

On the chart below, we track the cumulative total returns. Since 1989, the Treasury Index had a total return of 244%. The Municipal Index had total return of 165%. Since the income from the Municipal Index is tax-free, the returns are adjusted for tax rates of 15%, 25% and 36%. The tax rate where investors would break even from 1989 to 2005 would be 25% with an adjusted total return of 252%. ***So for most investors paying the AMT, it makes sense to buy public purpose municipal bonds.***

Although the returns of the taxable equivalent municipal index tend to track the Treasury index, it is notable that the municipal bond returns are more stable over time. If we mathematically model the return relationship, the municipal index has a *beta* of 0.62 and an *alpha* of 0.26. This means the change in the municipal returns is 62% of the change in the Treasury return from month-to-month and the municipal return is consistently 0.26% higher than the Treasury index. Generally, this means the municipal bond index is less risky and has a higher risk-adjusted return.

Cumulative Municipal Tax Equivalent Returns



¹ A combination of Merrill Lynch Treasury Agency Indices for Maturities of 3-5 years and 5-7 year.

² The Merrill Lynch 3-7 year Municipal Index.