

## July 2005

In July, municipal yield reversed 20-22 basis points through ten years in a mostly parallel shift we anticipated after the strong rally in the second quarter. All economic data reported in July seemed to confirm that the economy is growing at a moderate pace and inflation is within a range from 2.5% to 3.5%. The FOMC should continue to raise short-term rates through at least their November meeting; most economists expect the Fed Funds rate to end the year at 4%.

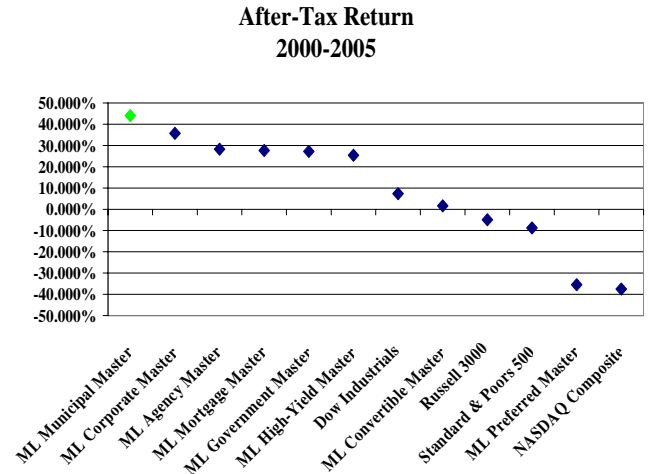
Two areas of the market that had unusual performance were the tobacco settlement backed bonds and alternative minimum tax bonds. The tobacco settlement bonds depend on payments from tobacco manufacturers based on the revenue generated from the sale of cigarettes in each state. According to the Merrill Lynch Tobacco Bond Index, the returns on these bonds have been +13% year-to-date. We believe the bonds represent a significant risk to investors' capital as the bonds are still subject to litigation and corporate credit risks. Some brokers have begun to tout AMT bonds as a potential gain if the AMT is rescinded. The change would cost about \$1 trillion in tax revenue. We believe this will limit any success in eliminating the tax.

Our portfolio strategy remains neutral to interest rates because the economic data is mixed and, as the FOMC statement indicates, is suggesting balanced growth /inflation risk. The yield curve has flattened and we are moving to a more neutral exposure to yield curve shifts. We are purchasing bonds to fill the barbell strategy and achieve a more level distribution of maturities.

### Municipal After-Tax Performance

The May issue of Lehman's municipal market commentary presented a graph showing that municipal bonds were the best performing investment on an after-tax basis over the last five years. We recreated the graph from data available from Merrill Lynch and Bloomberg total return indexes. Using the top individual tax rate for taxable interest, the reduced 15% tax rate on dividends and a 20% capital gains/losses rate, we found that the ML Municipal Master had an after-tax return over the last five years of 44.10%. This compares favorably to all other indexes like the ML Corporate Master at 35.70%, the ML Government Mater at 27.22 % the Dow Jones Industrial Average at 7.375% and NASDAQ at -37.524%. (See Chart 1).

Chart 1: Five Year After-Tax Returns



This strong performance was during a major sell-off in equities. We thought it made sense to go back 10 years and see if the after-tax return model holds up as well when we include a very strong rally in equities. We included the ML Municipal 3-7 Year Index to represent the intermediate municipal bond market. Chart 2 represents the ten-year after tax returns for the indices ranked by risk using the standard deviation of returns. The intermediate municipal index had an annualized return of 5.87% with the lowest risk. The best fixed income return was the ML Municipal Master with an after-tax annualized return of 7.13% compared to the DJIA at 7.04% and NASDAQ at 7.59%.

Intermediate municipal bonds have offered strong returns with limited risk for taxable investors. Breckinridge specializes in managing intermediate municipal bond portfolios for individuals to achieve high after-tax income with limited capital risk.

