

September 2005

In September, yields rose across the curve as hurricane Rita threatened the Gulf Coast refineries and the Federal Reserve moved the Fed Funds rate up to 3.75%. When Rita missed the Texas oil refineries, yields began to rise on news of continued growth and lower oil prices. Toward the end of the month, gas futures fell because demand dropped due to high pump prices. The bond markets responded to stronger than anticipated Durable Goods Orders and the potential for liquidation of bonds from Property and Casualty Insurance Companies to cover the losses from Katrina and Rita. New issue supply of municipal bonds remained very strong, up 15% over 2004 year-to-date issuance. For all the supply, municipal yields have continued to be more stable than comparable Treasury bond yields. For funds that are hedging, this mismatch in performance reduces the effectiveness of hedging strategies and can add risk.

Our portfolios are positioned in a neutral stance over the yield curve. We are slightly favoring three to eight year maturity bonds because the yield curve remains relatively flat. Our average quality remains at AAA and heavily weighted in the General Obligation and essential service sectors. Account durations are targeted between 4.05 to 4.35 years to match benchmarks' durations of ~4.24.

MBIA

MBIA is being investigated for financial reporting of risks associated with their purchase of Capital Asset Research. Barron's article "MBIA's 'Black Hole'", October 3, 2005, points out that the SEC and New York Attorney General Eliot Spitzer are investigating whether MBIA had fully disclosed all financial risks. We have focused our credit research on insured bonds to review the underlying credits and be sure they are stable without insurance.

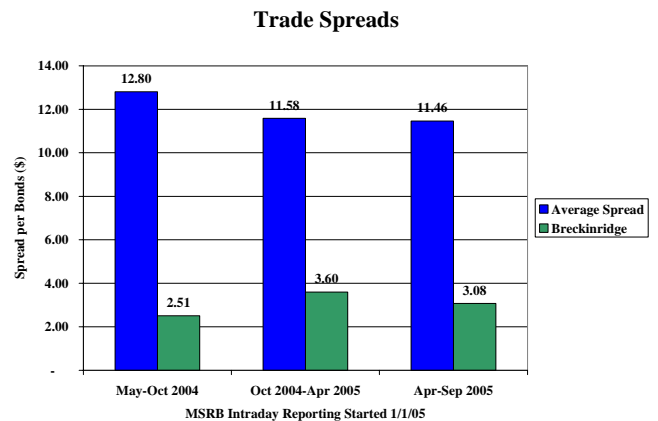
Tax Reform

Talk about tax reform is always relevant to municipal bond investors and thus, we continue to closely monitor deliberations from the President's Advisory Panel on Federal Tax Reform (taxreformpanel.gov). After several delays, a recommendation from the commission is scheduled to be released by Nov. 1. While there's some discussion about eliminating tax on investment income, we think the likelihood of such proposals gaining traction in the current political environment is extremely remote. Nonetheless, any discussion along those lines could be seen by the market as threatening the tax preference enjoyed by municipal bonds. This, in turn, could create some temporary volatility in the municipal market – particularly in the longer maturities and among leveraged, hedge fund investors. Should the sell-off extend to the intermediate part of the curve, we would view it as an opportunity lock in relatively attractive yields for Breckinridge portfolios.

Municipal Trading Spreads

At the beginning of 2005, the Municipal Securities Rulemaking Board began requiring dealers to report all trades within fifteen minutes. The trades are then available to all municipal investors to help add liquidity and transparency to municipal trading. The reforms have had minimal impact on municipal trading. The chart below shows the average trading spreads for bonds reported by the MSRB that had traded from a client to a client during a single day. This selection reduced the market impact of the trades and gives a better view of the spread added to municipal bond offerings.

The overall spread in the market has narrowed slightly from an average of \$12.80 per bond to \$11.46 per bond for the periods before and after the change in reporting. The limited success in reducing spreads is mainly due to the variety of activity in the municipal market. The change for bond trades of \$1 million or more is from \$7.52 per bond to \$6.74 per bond. So "institutional" size trading adds value, but does not limit the spread as much as using direct relationships with regional dealers. Breckinridge gains access to the market through a wide variety of dealers to limit the spread we pay to an average of \$2.50 to \$3.50 per bond.



Why have spreads remained so wide? A major reason is the diversity of issuers and bonds. On Oct 4, 2005, 12,229 different issues traded according to the MSRB. Only 1,613 of these issues traded more than four times during the day. Although the trades are reported, transactions mostly take place in bonds that are rarely traded.

Breckinridge specializes in managing municipal bond portfolios. The value of execution by professional traders who have specialized in this complex market adds value to the portfolio at inception and throughout its life. By varying our investment strategy and recognizing value in the market, we can add to the return of a portfolio while limiting the market and credit risk.