BRECKINRIDGE CAPITAL ADVISORS

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In October, yields rose across the municipal curve by 15 to 20 basis points. The shape of the curve remained consistent with the 1-30 yr slope at 159 bp. The good news is that reinvestment rates have backed up to more attractive 4% levels in the long intermediate area of the curve. The key turning points during the month were the release of the FOMC meeting minutes that confirmed a concern that energy inflation will work through the economy and stronger than expected reports for CPI (up 4.7% year over year), Core CPI (up 2.0% year over year and at the high end of the assumed Fed range), and regional Federal Reserve economic reports of economic growth. Each of these reports helped push interest rates up. We are approaching the high end of the trading range for 10-year yields since 2002.

Our portfolios are positioned in a neutral stance over the yield curve. We are favoring six to nine year maturity bonds because we believe there is value when yields approach the 4% in this range. Our average quality remains at AAA and heavily weighted in the General Obligation and essential service sectors. Account durations are targeted between 4.00 to 4.40 years to match benchmarks' durations of ~4.20.

Calls – Extension Risk

Long-term (20+ years) premium, callable bonds have been a staple for advisors who try to increase yield without increasing the reported duration (the convention with these bonds is to report duration based on the call date). However, the additional yield is sometimes minimal while the amount of duration risk is significantly understated. Typically these bonds trade as if the call date is the maturity and are spread to shorter maturity bonds. As interest rates rise, the call is less likely to be exercised and the bonds are valued to their maturity date. The portfolio will have more price risk when rates are trending up, accelerating the loss of market value.

When yields rise, the bonds trade at a spread to final maturity instead of the call date. In today's market with a relatively flat yield curve, the difference in the yield of ten-year bond and a 30-year bond is 77 basis points. If a bond is purchased at a spread to the ten-year call yield, then the yield must jump an additional 77 basis points as the call becomes less likely.

The combination of lengthening and moving out the yield curve will accelerate the affect of rising yields. Breckinridge has focused on call protected bonds because we saw opportunities to buy safer bonds with better long-term value.

Evaluating Public Finance Leases

Leases in municipal finance make up a large segment of our market. Their credit structure can vary greatly. Analysts need to understand the terms of the lease, such as who the obligor is and what it is that is being financed. Unlike General Obligation bonds, where payment is assured by unlimited taxing powers, leases tend to tightly define a stream of revenues for the repayment of debt. If these streams are inadequate, the City, Town, County, or State may frequently promise to provide support. This can substantially lower interest costs to the issuer.

Breckinridge participates in the lease sector where tax-backing is found. Many states take advantage of this structure as it offers them a legal alternative to GO debt. The new paper is incrementally less secure, as reflected in a one-notch rating reduction, but trades close to that of the underlying municipality. The timely repayment of this moral obligation, whether appropriated annually or not subject to any kind of vote, is crucial to the municipality's credit worthiness.

Breckinridge does not participate in deals with lease structures where there is no general government backing, where the supporting revenue streams are from a non-essential service, or where there is a recognizable mismatch between the service life of the assets and the length of the loan. A view into our overall 8% allocation to leases shows we take advantage of insurance, while also keeping a keen eye on underlying ratings. The chart represents a breakdown of insured leases by underlying rating. The 6% reflected as 'NA/NR' are largely made up of tax-backed school district leases we regard as safe. Breckinridge internally rates all bonds on our system according to a ratings score. The methodology is available upon request.

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