

December 2005

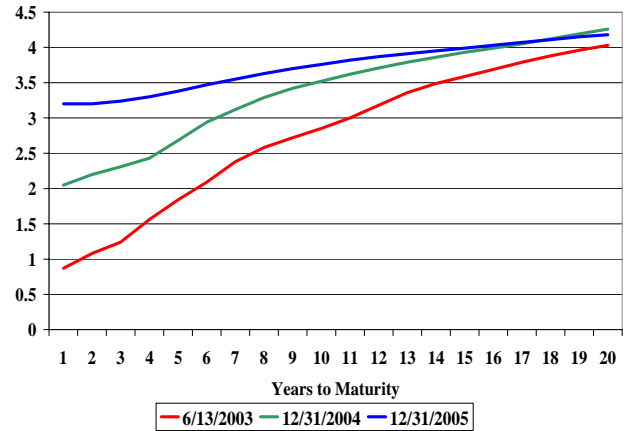
In December, the municipal yield curve flattened as one-year yields were unchanged at 3.20% while 10-year yields fell 11 bp to 3.76%. The decline in 10-year yields began December 12 when the Fed increased the Fed Funds rate to 4.25% but changed their statement to remove “accommodative” from the description of policy. This indicated to the market that the Fed may not increase rates as much as the market had originally anticipated. On December 22, the Personal Consumption Expenditure Core Price Index rose only 0.1% to 1.8% year-over-year. Inflation remained well within the Fed’s estimated target range. Other economic reports through the month indicated that economic growth remains steady and inflation measures were all stable. The market seems to anticipate stable growth and inflation going forward.

The yield volatility of the municipal market has dropped significantly over the last year. Annual yield volatility peaked at 21% in August 2004 and has since fallen to 8% at the end of December. This means the returns on municipal bonds are more stable. The main component of return going forward should be income flow which has risen substantially for intermediate bonds from last year. The Merrill 3-7 Year Index average yield rose from 3.08% to 3.61% in 2005. These are representative of the higher income flows from intermediate municipal bond portfolios. From the yield low of 2.12% in June 2003, the index average yield is 149 bp higher. The rate increase is the second highest in the index history, meaning the second weakest municipal market since 1988. Over this period the index total return has been 3.98%, 1.54% annualized. The positive absolute return given the weakness in the market shows the resilience of municipal intermediate portfolios.

Breckinridge is positioning portfolios in a more neutral stance to the market. We have lengthened accounts that were short to their benchmarks and begun to aggressively purchase in the middle of the curve. These strategies should help us take advantage of the flatter yield curve and the relative stability we have seen developing in the municipal market. With the decline in volatility, we are focusing more on certain callable bond structures. Our strategy is to buy bonds with calls that are less likely to be exercised. If we are correct and these issues remain outstanding past their call dates, the portfolios will receive an above market income stream to maturity. In addition, we have now begun to selectively purchase bonds in the airport and public power sectors. Both sectors have improving underlying fundamentals and offer attractive relative yields. The pace of deregulation in public power has slowed significantly and thus, competition is less of a threat today for municipal utilities. Meanwhile, public sentiment has begun to more heavily favor the virtues of

municipal owned, local and reliable power generation. Airports are also on more solid footing. Many have improved their balance sheets while taking significant steps to limit exposure to airlines.

MMD AAA-rated GO Yield Curve

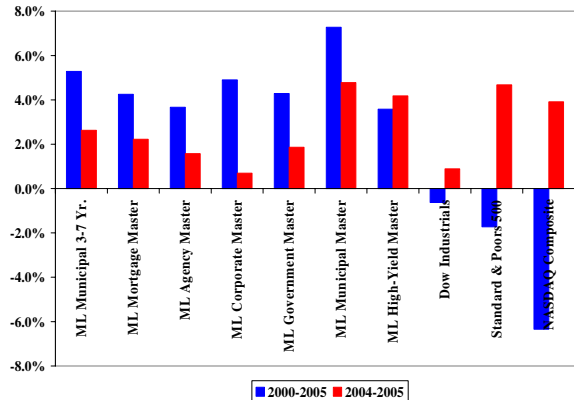


Comparative Returns

As mentioned above, the last two years have seen the second worst bond market for intermediate municipal indexes since 1988. Over this period the indexes have still generated a positive absolute return.

Since 2000, municipal bonds have had the best after-tax return among domestic indices for a tax payer paying the highest marginal rate. The ML Municipal Master Index (representative of all municipal bonds) had an after-tax annualized return of 7.27% and the ML 3-7 Year Municipal Index (representative of intermediate municipal bonds) had an annualized after-tax return of 5.30%. These were the best after-tax returns among all the fixed income and equity indices. This 2000-2005 returns are the blue columns on the chart below.

Comparison of Annualized After-Tax Returns for Various Indexes



Since the end of 2003, municipal bonds have had the best after-tax return among the fixed income indices.

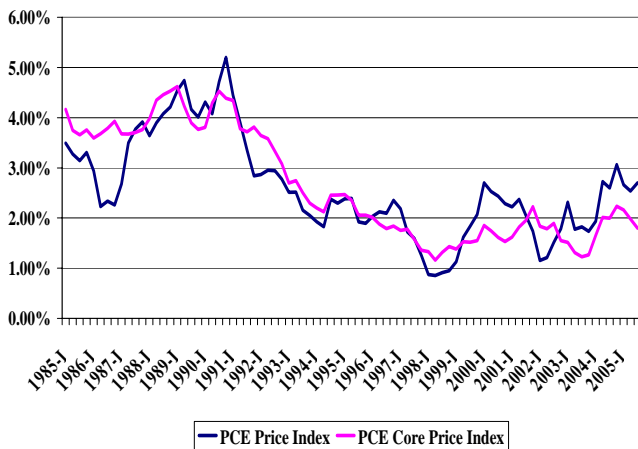
However, since the fixed income market had gone through some weakness, equity indices had higher annualized after-tax returns. The ML Municipal master had an annualized return of 4.77% and the ML 3-7 year Municipal Index had an annualized after-tax return of 2.62%. For example, the S&P500 had an annualized after-tax return of 4.68% over the same period. The 2004-2005 returns are the red columns on the previous chart.

From a return volatility and absolute return perspective, the municipal bond market has fared the weak period remarkably well compared to other asset classes. The result of this tumultuous market is higher tax-exempt investment yields that will create additional tax benefits through the rest of this investment cycle.

Outlook for 2006

In the year ahead, we expect moderate economic growth and inflation. The outlook is for municipal yields to stabilize and remain in the current trading ranges. Inflation remains in the Fed's "target" range according to several members of the board. Informally, 1.5% to 2.5% inflation seems to be developing as the target range for Core PCE Prices (see chart below) and the index has been firmly in that range since 1995. We believe the Fed will stop raising rates at either 4.50% or 4.75%. This will take pressure off the fixed income and equity markets in 2006. We have moved our model portfolio to a neutral duration stance to reduce exposure to any unexpected economic events.

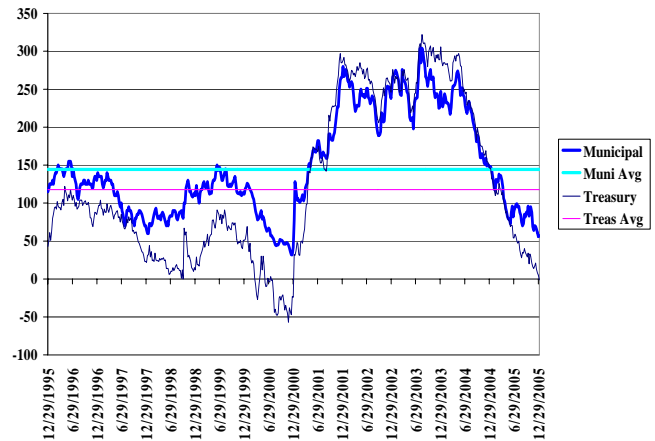
Personal Consumption Expenditures Price Index



The yield curve slope flattened dramatically over the course of 2005. The municipal slope fell from historically wide levels to near the narrowest levels in the last ten years. We believe that the curve should stabilize or

steepen over the course of 2006. To reduce the risk of a steeper yield curve we will continue to fill the middle of the curve. The impact of this trade will be better price performance as the curve gets steeper and increase the income from the portfolio by reinvesting in the cheaper area of the curve. We are continuing the process of reinvesting the short maturities from the "barbell" trade of 2004 to level the maturity structure and increase exposure in the center of the curve.

Weekly Yield Curve Slope 1-10 Yr



Although most measures of inflation have been benign, benefit expenses are a continuing concern for both US industrial companies and state and local governments. Private industry has begun to address the problem with the year over year rate of increase dropping from 7.2% in the second quarter of 2004 to 5.1% in the third quarter of 2005. In the municipal market, we are concerned by the continued higher rate of increase in state and local government benefit costs, up 6.1% in 2005. In the June 2005 Newsletter, we discussed the building pension liability of state and local governments. We continue to research and monitor the impact and response of governments to the rising cost of benefits. The drop in the private sector growth is some comfort that the problem may have a solution that governments can use to gain control of these costs.

Benefits Inflation
Source: US Department of Labor

