

January 2006

In January, municipal yields were much more stable than Treasury yields. The 5-year municipal bond yield was up 4 basis points to 3.42% and the 5-year Treasury bond yield was up 16 basis points to 4.51%. Municipal bonds benefited from large maturity and coupon cash flow from the January 1 payments and a relatively light supply of new issue bonds. Most of the sell-off in bonds occurred at the end of the month. The key risks facing the market are the inflationary impact of the situations developing in Iran over nuclear plants, in Palestine with the election of Hamas and in the market over employment growth in the first quarter of 2006. Productivity of non-farm business labor fell -0.6%, the largest drop since 2000, and Unit Labor Costs rose by 3.5% in December. Taken together the numbers indicate an increasing cost of labor that may translate into higher core inflation. In addition, February volume of municipal and Treasury new issues will be stronger than January.

A unique risk in the municipal market is secondary supply from hedge funds and taxable crossover buyers. As municipal bonds held their value through January, we began to see crossover buyers, money managers who buy municipals as a spread trade to Treasuries, liquidating positions to capture the better relative performance. Leveraged hedge funds may begin to liquidate holdings because the yield curve is much flatter and their hedges have excess profits due to the municipal bond's relative performance. Most of these investors purchase longer maturities than Breckinridge, so the impact should be larger for longer bond portfolios.

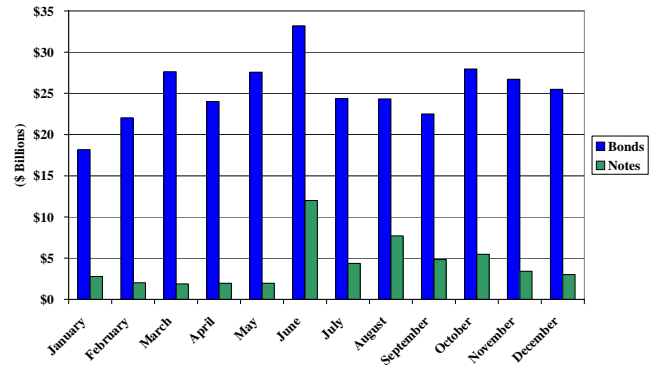
Breckinridge has taken a neutral stand to the market given the balanced risks in the market. We are buying heavily in bulleted maturities, concentrating on 2009 to 2014 maturity bonds. When we can find longer bonds with yields close to or above 4%, we have purchased ten to twelve year maturity bonds. Our maturity structure for most accounts is more bell shaped, reflecting our belief that the municipal yield curve will not flatten much further. This strategy should protect our portfolios by locking in income if yields should fall and preserving capital through a neutral to short market exposure if rates should rise.

Seasonal Cash Flow of the Municipal Market

Municipal bond investments tend to have highly seasonal cash flows throughout the year. The major reasons for this are tax payments in April paid by municipal bond holders, municipal issuers' June 30 fiscal year-end and bond issues maturing at the start of the next fiscal year on July 1, so coupon and maturities tend to be at the end of the fiscal and calendar years.

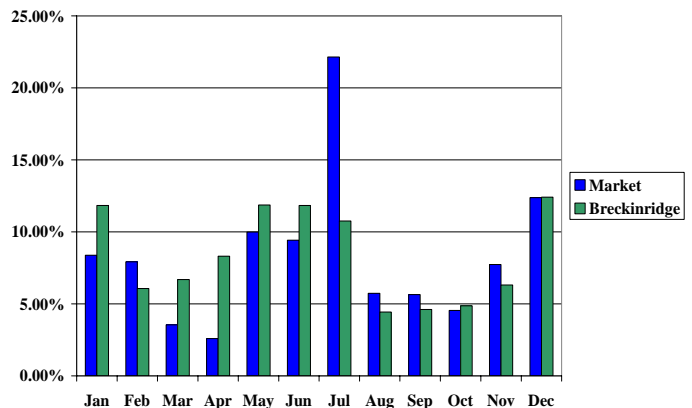
Supply of municipal bonds also follows seasonal patterns in most years. Most municipal issues need public approval through ballot measures. Issuance will tend to be heavier in months following elections in March and November.

Average Monthly Issuance 1997-2006



The cash flows in the market are somewhat mismatched because issuance and maturity-coupon flow occur at different times of the year. In addition, tax payments in April occur during an upswing in municipal bond issuance. Conversely, issuance is very light over summer months following the large July 1 interest and coupon payment. The cash flows in the market will tend to make municipal bonds cheaper relative to taxable issues from February through June and much more expensive in July through September.¹

Seasonal Cash Flows of Municipal Maturities and Coupons



At Breckinridge, we are very aware of the mismatched cash flow and seasonal effects on portfolio values. Instead of concentrating cash flow in July as the market does, we spread the cash flows more evenly through the first half of the year. This strategy allows reinvesting at the best relative seasonal values and spreads the risk of reinvestment over a wider range of dates during the year.

¹ Market cash flows in the chart are based on the averages of bonds in the Merrill Lynch 1-12 Year Municipal Bond Index.