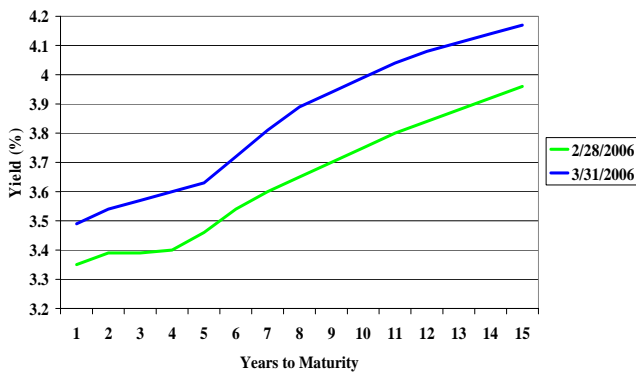


## March 2006

In March, municipal bond yields were higher over the course of the month and the municipal yield curve was steeper with the five to ten-year yields rising more than short-term rates. As expected by the market, the FOMC raised the benchmark Fed Funds rates to 4.75%, the fifteenth increase in as many meetings since June 2004. The rise in rates led to a steeper yield curve (chart below). The sharpest incline in the curve remains in the 6 to 10-year area of the municipal curve. Interestingly, the long-end of the municipal curve was significantly weaker than shorter maturities reversing the strong flattening of long maturity bonds over the last twelve months.

**AAA General Obligation Bonds - Institutional Offered Side**



Source: Thomson Financial, Municipal Market Data, 2006.

Rising yields in long maturity issues will begin to reduce the value of long bonds with short calls. Over the last year, we have discussed the risks associated with portfolios that report a short duration based on the calls on long maturity bonds. With long-term current yield levels exceeding 4.50%, the preponderance of 5% to 6% bonds (72% of the S&P Municipal Index) longer than 15 years to maturity will begin to trade more to maturity yields than call-date yields. Many portfolios will see a significant increase in market price risk if yields continue to rise as they have in the first quarter of 2006. We continue to recommend limited exposure to callable structures to reduce the extension risk of portfolios.

Breckinridge's municipal strategy remains neutral to the benchmark duration with an overweighting in the center of the yield curve. Our increased yield curve exposure in intermediate maturities should help portfolios as the yield curve moves steeper. With the Federal Reserve continuing to see inflation stable and moving interest rate policy to restrain inflationary expectations, we continue to believe the interest rate markets should remain stable. The likelihood of the next major move in the yield curve to a steeper slope has begun. We continue to try to lock-in yields higher than 4% for intermediate-term bonds when possible.

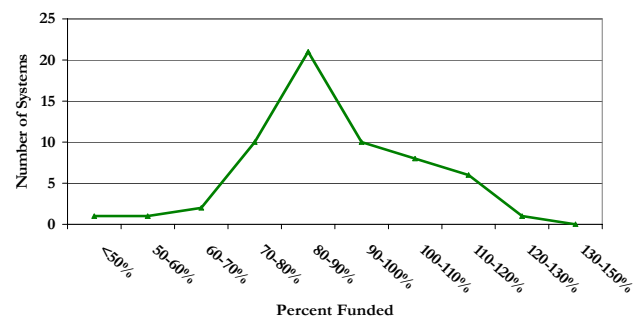
## Pensions

The latest figures on the total unfunded liability for public pensions range from \$280 billion for the states, on up to \$750 billion when state and local governments are combined. At the State level, defined benefit plans have promised an accumulated \$947 billion dollars to future retirees. The new GASB 45 rules, for other post employment benefits (or OPEB), are also expected to add as much as an additional trillion dollars.

Much has been written about state pensions, while relatively little has come out regarding the funding status or nature of the liabilities faced by local government. In either case, attention needs to be paid to both the issues of underfunded pensions and OPEB, as the two may each cause debt levels to rise. Our concern with local credits is rooted in their ability to prudently manage these sizable liabilities amid what are typically fewer resources than possessed by their state counterparts. While we do take encouragement in knowing that approximately 55% of local pension contributions are state subsidized, we need to be prepared to respond to the choices made by these municipalities as the GASB 45 numbers become known. Their options are to continue to operate on a pay-as-you-go basis, to fund potentially through bonding, or to effectively let the liabilities sit on their financial statements. We can not be sure what tools they will use, but from the figure below, we can get a picture of how much they may need to use them.

The chart shows a distribution of the funded status among 60 large local pension systems. It does not include any values for OPEB. Our focus will be on the lower outliers, who face the toughest decisions going forward. Those trailing significantly beneath a funded status of 70% are least well positioned to rectify their situation without going to the capital markets. Any bonds for communities in this region will either be avoided, or have their debt capacity reviewed to establish that no significant ratings pressure will result from additional borrowing.

**Distribution of Funded Status (60 large local U.S. Systems, by Market Value 2004)**



Source: Wilshire Consulting, 2005 Report on City and County Retirement Systems.