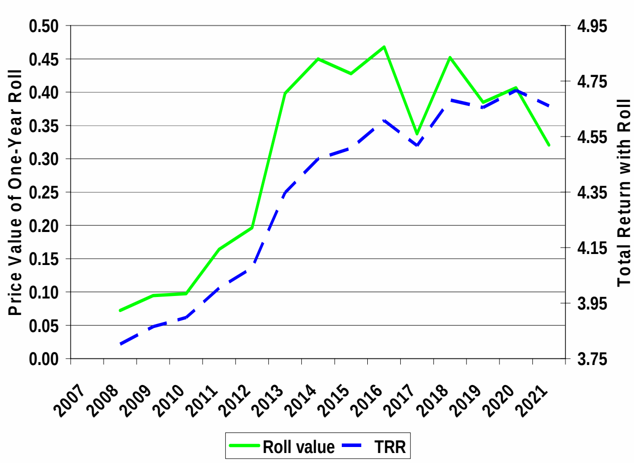
In June, the municipal market reacted badly to the latest round of FOMC tightening and increased expectations for further increases. The FOMC raised the Fed Funds rate to 5.25%, the seventeenth such increase at consecutive meetings. The US Treasury 10-year was up 1 basis point in June compared to a significant shift in the municipal 10-year yield up 12 bp. Some of the municipal yield change was due to more new issue supply and some was due to the municipal yield ratios correcting after the June maturity reinvestment activity slowed. In addition, the flat municipal yield curve is reducing the demand from leveraged funds. These funds have provided strong support for longer maturities in the market. As this demand dries up, we look for some steepening of the yield curve in long maturities.

We have adjusted our strategy to lengthen portfolios slightly to take advantage of the value on the curve in the 2013-2015 maturity range. The graph below shows the price increase and total return for holding a bond for one year if the yield curve remains the same. With a relatively flat curve from 2007 to 2012, the value of the roll is very low. However the value jumps for the years 2013 to 2016. Since we believe that the next major move for the yield curve is steeper, we are concentrating our purchases in these maturities. In addition, we are purchasing more 2007 maturities in order to limit the market exposure of accounts. This combination of holding the long end of the indexes and some very short maturities should provide limited market risk with a higher income flow through the next twelve months. In addition, as the short maturities are rolling off, we will be able to reallocate portfolios in a more tax efficient manner in the coming year.

Value of the Roll in Total Return



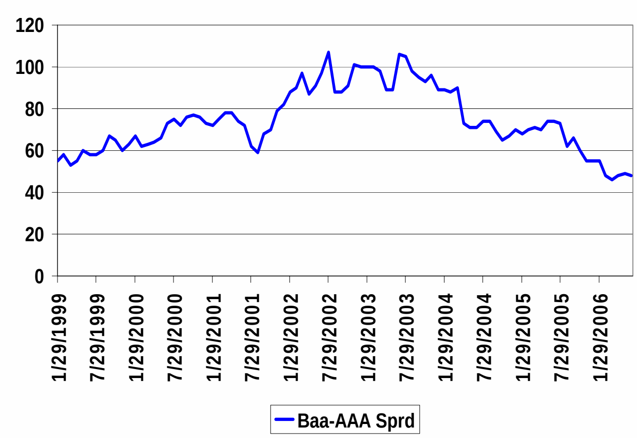
Source: MMD Yield Curve and BCA Research.

Upgrade and Shorten Portfolios – Why Now?

For typical brokerage and high yield portfolios, the sharp movement to a flatter yield curve and tight credits spreads makes this a good time to look at upgrading, shortening and adding call protection to client portfolios through Breckinridge management. Many investors have tried to reach for yield by purchasing lower credit quality and long maturity bonds trading to their short call dates. This trade has worked out for some because credit spreads have tightened dramatically in the last two years. In addition, the flatter yield curve has not caused the long bonds to extend beyond their call dates. Now, however, credit spreads are very tight and many long bonds with calls are approaching the yields that will cause the bonds to trade to their long maturity dates, extending portfolios in the worst market conditions.

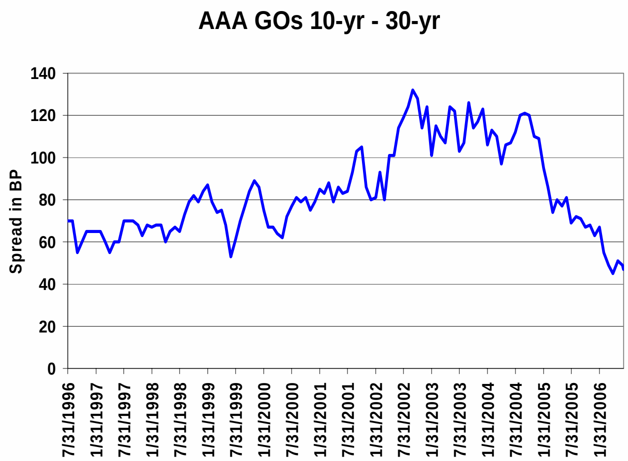
Credits spreads have narrowed substantially in the last two years. From the highs in 2003 when high yield bonds paid over 100 bp in additional yield, the spreads have fallen to the lowest levels since 1999. At a yield spread of only 49 bp, the additional risk of low quality credits can be upgraded at relatively little change in the yield of the portfolio.

Comparison of Credit Spreads
Source: Municipal Market Data, 2006.



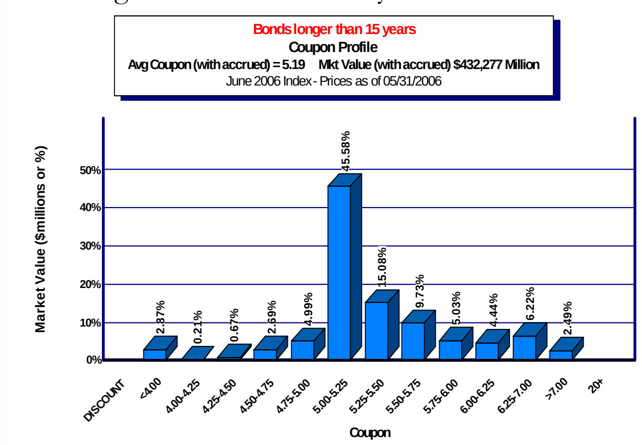
Source: Municipal Market Data.

Portfolios that have extended to try to increase yield have an opportunity to decrease market risk and maintain more of the portfolio yield as the yield curve has flattened substantially. The following chart shows the spread between a AAA-rated 30-year bond and a AAA-rated 10-year bond. The difference in yield is at its lowest point in over ten years. At Breckinridge we believe the best riskreward trade-off is in the intermediate area of the municipal yield curve. With the curve relatively flat, the cost of transitioning a long account is minimized in terms of the portfolio yield.

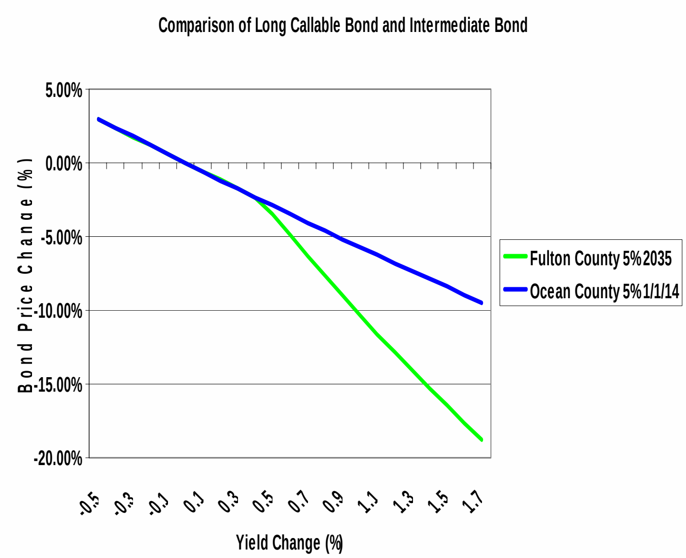


Source: Municipal Market Data.

In addition to reducing market risk, shortening the portfolio in current market conditions will reduce the extension risk of portfolios invested in long maturities with short calls. Looking at the Standard & Poors Municipal Bond Index of bonds with maturities longer than 15 years, the preponderance of coupons is in the range of 5% to 5.5%. This means a major shock to market values of long maturity bonds as 30-year yields approach 5% (currently the 30-year high grade yield is 4.60% and 30-year BAA yields are 5.04%). The performance of these bonds will suffer as the bonds begin to trade to maturity instead of to call.



Below is an example of the expected price performance of a long bond with an 8-year call compared to an 8-year maturity bond. If yields move lower, both bonds will have similar price changes. If yields move higher, when the long bond begins to trade to its maturity, the price of the bond will fall at an accelerated pace for any change in yield. The net impact is the portfolio will lengthen in weak bond markets and shorten in strong markets. We believe the shorter maturity will help protect capital and, with a flat yield curve, maintain the income stream.



Source: BCA Research using Bloomberg bond descriptions for Fulton County, GA bonds due 2035 (callable 2014) and Ocean County NJ bonds due 2014.

Overall, Breckinridge believes the market is offering a unique opportunity to shorten portfolios to reduce market volatility and upgrade credit quality and reduce call extension risk.

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