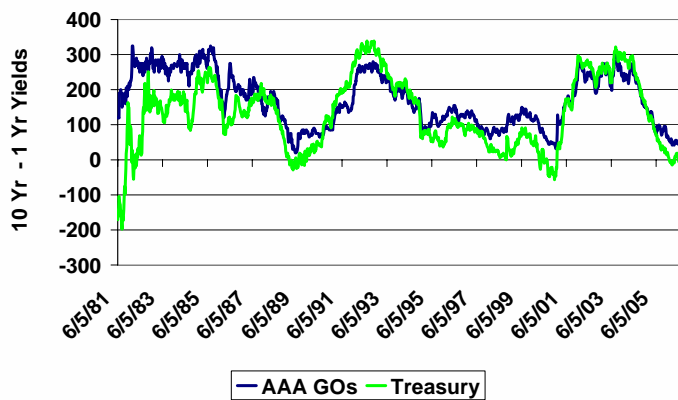


In July, the municipal market retraced the losses of June when the possibility developed that the FOMC may not raise rates in August. At the early August meeting, the rate was left unchanged for the first time in over two years. With the Fed Funds rate holding at 5.25% and economic indicators beginning to show a slowing in the economy, the treasury and municipal markets began to see lower rates in maturities five years and longer, with drops of 13 to 15 basis points. The yield curve remains very flat at 36 bp between one and ten year municipal yields, the narrowest since the 1989 low of 20 bp.

### Comparison of Yield Curve Slope

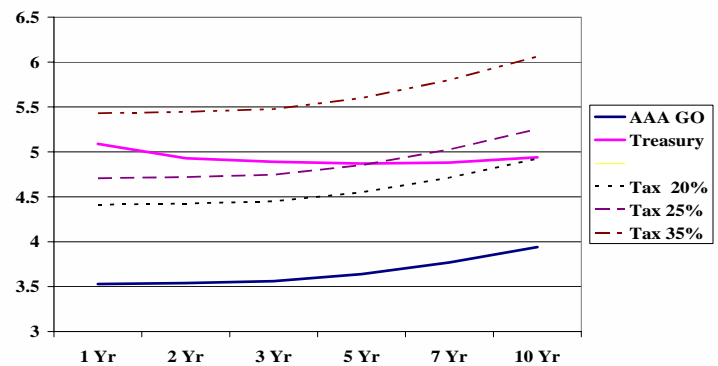


We continue to target our portfolio durations slightly long of their benchmarks. For the five-year benchmarks, this means a targeted duration .10 to .25 years long of the benchmark. This fits with the current trend toward moderating to lower rates. We are focused on the 2013-2015 maturities because this is where we see the best value on the yield curve and these bonds will be more bulletted to the index going into 2007. The next major yield curve shift should be to a steeper yield curve from the current historically flat curve, but this move may not occur until the FOMC begins to lower the Fed Funds rate. Most economists anticipate a lower rate no sooner than early 2007. We are also building a larger position in 2007 maturity bonds in most portfolios. This hedges the portfolio in two ways; it offsets the longer average duration of the 2013-2015 bonds and offers the opportunity to reinvest proceeds in the market when the yield curve steepens without creating capital gains or losses. We also believe this a great time to upgrade and shorten long bond portfolios. With a flat curve, moving maturities in to eliminate extension risk from long callable bonds is cheaper than it has been in recent years. Tight credit spreads offer the opportunity to upgrade quality with less than the usual yield give up.

### Hybrid Accounts for Lower Rate Taxpayers

Breckinridge offers an alternative investment strategy for investors paying lower tax rates or paying the alternative minimum tax. The portfolio is invested in a combination of tax-free municipal bonds, taxable municipal bonds, treasuries and agencies. The account generates federally taxable and tax-exempt income that may be exempt from state income taxes. The account is managed to the individual tax situation of the investor to maximize the after-tax income of the portfolio without adding credit or duration risk to a typical municipal bond account.

Taxable Equivalents Compared to Treasury



This strategy takes advantage of the relative shape of the municipal yield curve compared to taxable alternatives. Our specialization in municipal credits and valuation gives us a unique strength in managing the taxable municipal portion of the account. Taxable municipal bonds we buy include General Obligation and essential services revenue bonds. These are the same high grade bonds we would buy in the tax-exempt market. The issues are taxable because the use of the funds may include private purposes but the payment of the bonds comes from the same source as tax-exempt bonds of the issuer. Taxable municipal bonds trade at a spread to the treasury curve, so the shape of the curve and yield changes will more closely reflect other taxable bonds. The bonds tend to trade at an equivalent or higher spreads to treasuries than comparably rated corporate credits.

Depending on an individual's tax situation, the hybrid municipal account may be very attractive. The chart above shows the relative taxable equivalent yields for municipal bonds versus the treasury yield curve. Currently, an allocation to taxable securities in the shortest maturities would have a higher after-tax income than tax-exempt bonds for a taxpayer in the 25% bracket.