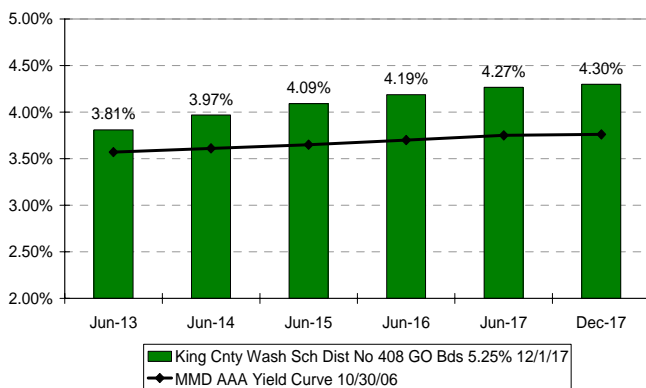


In October, municipals were basically unchanged as the market settled into a wait-and-see attitude toward Fed policy and economic data. One-year municipal yields rose about 2 bp and 10-year municipal yields fell 4bp to further flatten the yield curve to an 18 bp slope from one to ten years. This is the flattest municipal yield curve since the Municipal Market Data started tracking the municipal yields in 1981. It mirrored the continued inversion in the treasury yield curve, which most economists believe reflects a slowing of economic activity. The weakness in commodity and energy prices further supported the view that cyclical inflationary pressure may be peaking. At the same time, other reports indicated the economy remains relatively sound despite softness in housing. These along with the solid gains in equity markets kept interest rates in a fairly narrow range during October.

We continue to target our portfolio durations neutral to slightly long of their benchmarks. For the five-year benchmarks, this means a targeted duration .10 to .15 years longer than the benchmark. We are looking for the best value on the curve and in call structure. We still expect the next major yield curve shift should be to a steeper yield curve from the current historically flat curve, but this move may be delayed into late 2007.

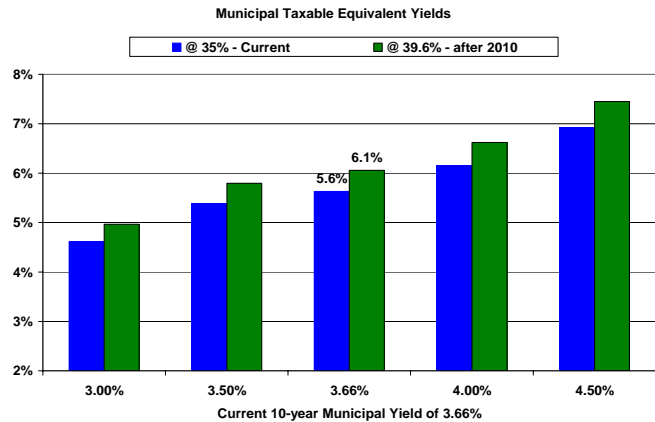
We have actively sought out 8-10 year bonds that are callable in 6-9 years (approximately 39% of October purchases). The focus is to purchase bonds from issuers that are less likely to exercise the calls in an economically efficient manner. Oftentimes a small issuer will not call bonds early due to the cost of issuance to refinance the debt. The bonds are purchased at a positive yield spread to the bond's maturity. The chart below shows the additional yield if the bond is not called.

Breckinridge Callable Bond Purchase versus AAA Yield Curve



Outlook for Municipal Bonds after the Election

The mid-term election results changed control of the House and Senate from Republicans to Democrats. The shift changes a number of assumptions in the market about tax code change. Of most interest to municipal bond investors is the expiration of the 2001 reforms to the tax code at the end of 2010. The chart below shows the tax equivalent yields for municipal bonds at the current and future effective tax rates.



In addition, the lower rates on dividends and capital gains are also set to expire, making competing investments less attractive to municipal bonds. We believe that municipal bonds should become more attractive to investors as other investments lose their tax advantages.

Another change that may be in the offing is a proposal from Rep. Charles Rangel, D-NY, who is expected to become the chairman of the House Ways and Means Committee, to repeal the alternative minimum tax (AMT). The AMT was not adjusted for inflation when added to the tax code and has crept down to hit many middle income families instead of the high income targets. The effect is particularly problematic in high tax states like California and New York. The AMT was not repealed earlier because it would reduce tax revenue. If the tax provisions are allowed to expire, the additional revenue will make the AMT easier to phase out. At Breckinridge, we will continue to avoid any purchases of AMT paper due to the lower credit quality, less attractive structure, and minimal yield pick up of the bonds that are generally exposed to the AMT.

On a tax related story, we continue to follow the Supreme Court appeal of the Kentucky tax on out of state municipal bonds. The decision could have a long term effect on the state preference of municipal bonds, particularly in high tax states. We will follow up as the story develops.