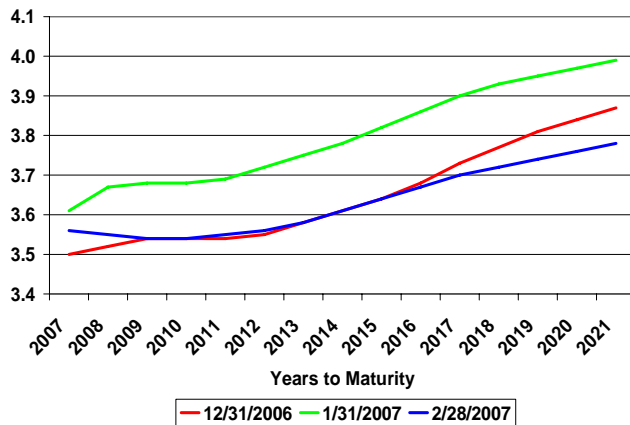


February saw a near total reversal of the January markets. As January was dominated by fear of the economy accelerating, the February reports reversed much of the data and showed the economy slowing. After a year with very low volatility in both fixed income and equities, this year is beginning to show much higher volatility due to the greater uncertainty in the economy. Usually, March and April are months when the municipal market will under perform due to tax payments and represent a good buying opportunity. This year, the higher volatility in the markets will make this period less predictable and require greater vigilance to find and exploit opportunities in the market.

MMD AAA-rated GO Yield Curve



We continue to believe that the yield curve should steepen by the end of 2007 or first quarter 2008 as the FOMC begins to lower short term yields. The Fed Funds futures contracts indicate a 100% chance of a cut by the end of the summer and a 100% chance of a further cut before year-end. The portfolios are investing current maturities more heavily in the 2012-2013 range (final maturity or effective call date). We remain focused on high grade issues in GO and Essential Service sectors with the addition of selected local Electric Utilities and Airports. With the strong rally in fixed income in late February, extending into early March, we are slowing our investment timing for new accounts. Usually, we expect to be fully invested in six to eight weeks. From the end January, this timing was compressed by the availability of bonds and the weakness of the market. Over the next month, we will be more selective with purchases.

For Taxable and Taxable-Tax Exempt Hybrid accounts, we are pursuing a similar strategy of moving duration longer using taxable municipal bonds to increase duration and buying Treasury notes and Agencies for liquidity. We have added short callable Agencies to pick up yield. We are filling in the maturity structure in 2011-2014 to prepare the portfolios for the eventual steepening of the Treasury yield curve.

Taxable Commentary

As mentioned earlier, the increase in market volatility during the latter half of February had a pronounced effect on most sectors within the fixed income market. In the taxable market (particularly the credit and mortgage sectors) investor sentiment was heavily influenced by the deterioration in the sub-prime mortgage market and further weakness in housing. As defaults increased and several mortgage companies were forced to declare bankruptcy, investor fears of contagion caused most spread sectors to under perform treasuries. Lower quality bonds, particularly emerging market and high yield debt, experienced a sharp widening in spreads as investors fled from riskier assets to the high quality treasury market. Even very high quality corporate bonds and mortgages were negatively impacted. In particular, brokers, banks and finance companies were the hardest hit as speculation about the degree of exposure to the sub-prime mortgage market became increasingly negative. Additionally, it is important to note that the taxable municipal market remained firm amidst the swirl of negative headlines and concern in the credit sectors.

Spread widening within the credit sector has been a highly anticipated event given the historically rich valuations, and an environment of increasing event risk. While the recent spread widening is minor when viewed from a long term perspective, we anticipate that yield spreads will remain under pressure to widen further as jittery investors react to upcoming events and economic data.

Municipal Hedge Fund Performance Characteristics

Leveraged municipal trades (TOB) outstanding have grown dramatically in the last few years. This strategy has been used to take advantage of the relatively steep slope of the municipal yield curve. The improved liquidity in municipal related hedge product also contributed to the growth. TOBs offer enhanced tax exempt cash flows but the hedges used are prone to great price volatility. This internal volatility of asset pricing translates into higher overall volatility than a typical intermediate municipal bond investment.

TOBs tend to purchase long maturity municipal bonds to maximize the carry value of the trade and then hedge the positions using long intermediate swaps that match the duration to call of the long bonds. This creates a mismatch between the hedge and the bond holdings which is exacerbated by the use of LIBOR swaps which introduce a cross market risk. Over the last nine months, municipal yield ratios to Treasuries have changed dramatically. 5-year yields have cheapened from 72.8% to 80.1% and 10-year yields cheapened from 78.1% to 81.8%. Meanwhile the 30-years richened from 89.3% to 84.1%. Therefore, a TOB would currently be leveraging exposure to a rich part of the municipal curve and selling in a cheap area of the municipal curve or adding intermarket risk.