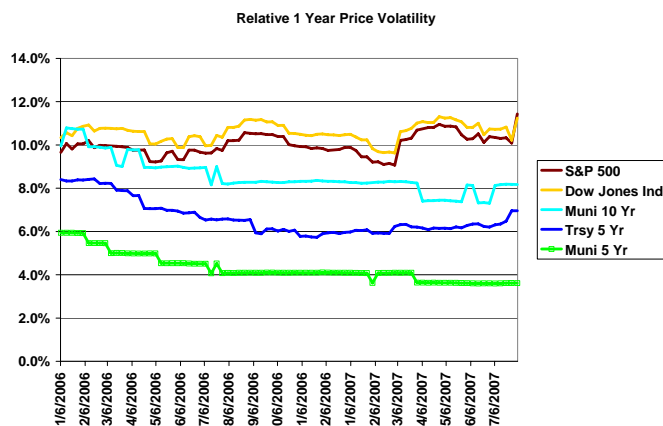


Monthly Review

The volatility and spread widening due to sub-prime mortgage fears referred to in last month's commentary seemed to reach a crescendo in July as investors sought the safety of U.S. Treasuries in a flight to quality. Interest rates across the curve declined with the intermediate sector of both the Treasury and Municipal markets declining more in a bullish steepening of the yield curve. Higher quality sectors of the fixed income market posted strongly positive returns, and longer maturity Treasuries were the top performers. The ten year Treasury note began the month at a yield of 5.02% and ended the month at 4.73%, while the two year Treasury note declined even more from 4.85% to 4.51%. Municipal yields declined to a much lesser extent with the 10-year AAA falling from 4.07% to 3.97% and the 2-year AAA falling from 3.70% to 3.65%. At the same time, mortgages, high yield and investment grade corporate credits (especially anything related to the housing market and mortgages), were hard hit as yield spreads widened to levels last seen in 2003.

In contrast to the turmoil in the taxable credit and mortgage markets, the tax-exempt municipal market exhibited its characteristic low volatility with high returns. As is typical in periods of high volatility, the municipal bond market remains a refuge and is often a recipient of the flight to quality trade. The chart below illustrates the volatility of the Dow Jones Industrials, S&P 500, the 5-year Treasury note, and the AAA-rated 5 and 10 Year Municipal yields over the past year, and the low volatility of the municipal bond market is clearly visible.



Breckinridge Strategy

Our investment strategy in both the tax-exempt and taxable portfolios remains the same; constructing portfolios with a slightly longer duration than the benchmark, with an emphasis on high quality, intermediate maturity bonds in anticipation of a further steepening of the yield curve.

After the Treasury market's sharp move up in price in July, the tax-exempt market is more attractive with 10 year municipals yielding 84 % of treasuries.

The taxable portfolios have been a beneficiary of the flight to quality mentioned above, and while the market has begun to show some signs of stabilizing, we believe the volatility and increased discrimination amongst various credits will remain for quite some time. Both Agency and taxable municipal spreads widened in sympathy with other spread sectors, yet was contained and we view the current levels as attractive.

Sub-Prime Contagion – Spillover to the Muni Market

The credit woes emanating from the sub-prime mortgage sector have affected many other asset classes, and the municipal market has not been an exception. One sector in particular that was impacted was prepaid gas bonds. Yield spreads of these bonds significantly widened during the month of July reflecting investors' concerns over the creditworthiness of the underlying obligor.

Prepaid gas deals were issued following the deregulation of public utilities with the National Energy Act of 2005. Public utilities have historically favored stable pricing and long term contracts, two things which the deregulated energy markets have taken away. With new rules for engagement, public power and structured finance are combining. The stable energy pricing that results is beneficial, but bond holders are left with more questionable security. The issuers of the bonds are typical, like Kentucky Public Energy Authority or Indiana Bond Bank. However, the funding derives from swap transactions that lock in the price of energy. Neither a corporate guarantor, nor the commodity swap counterparties, is beholden for debt service. The weakest rated corporate party to the transaction establishes its rating. With the turmoil ratings agencies have recently faced in over-rating the credit qualities of sub-prime and the structured corporate financial nature of these transactions, we have chosen not to participate in the new structures.

Another sector touched by sub-prime worries that could affect the municipal market has been bond insurers; especially MBIA and Radian. Both companies' stock and credit default swap prices have been affected by fears that the companies' exposure to the sub-prime mortgage market will impact their balance sheets and impair their ability to insure bonds. Given the available information, we do not believe this scenario will unfold.

That being said, both the prepaid gas deals and the worries about bond insurers underscore our belief that it is important not to rely solely on the AAA rating generated from an insured bond, but to know and understand the underlying credit and adhere to our strict parameters in purchasing municipal bonds.