

Monthly Review

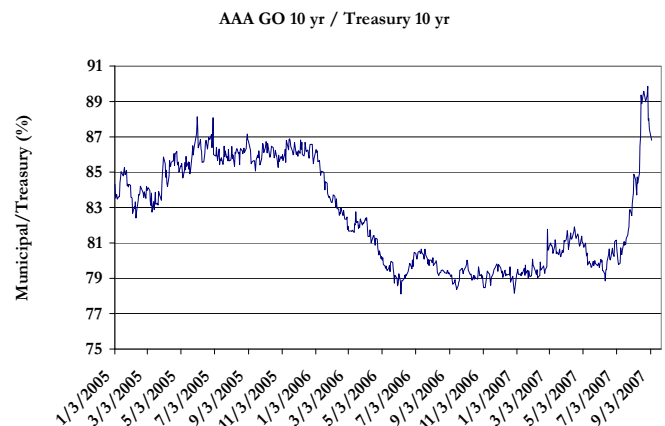
The flight to safety that began in late June gathered steam in August as investors bought U.S. Treasury securities at the expense of other fixed income asset classes. Fears of sub-prime mortgage contagion intensified and credit market liquidity dried up as several hedge funds, mortgage companies and various investment vehicles were forced to close. The ever elusive pricing transparency of sub-prime mortgages was revealed as investors unsuccessfully tried to liquidate securities in a market with few, if any, buyers. U.S. Treasury securities strongly benefited from risk aversion and the sector returned 1.57%. The ten year Treasury note was the top performer returning 2.09% for the month. The Treasury yield curve underwent a bullish steepening as short maturities declined more than long maturities in the flight to quality. In contrast, the municipal bond yield curve steepened from a rise in rates, as long maturity bond yields rose more than short maturities due to events more specific to the muni market. Returns in the municipal market lagged, particularly in longer maturities and lower quality market segments. This is evident in the decline in the Lehman Long Bond Index of -2.26%, and the Lehman Baa Index decline of -3.78%. The Merrill Lynch 1-12 Year Municipal Index returned a positive .52% representing intermediate maturity bonds. Taxable municipal bonds also lagged Treasuries.

Not surprisingly, the municipal bond market was affected by the spillover from the dislocation of leveraged municipal buyers' positions. As we have discussed several times over the past year, leveraged municipal bond funds have been at risk of sharply underperforming in a flight to quality environment (lower short term treasury yields) such as the one in August. As treasury yields declined, the leveraged funds were squeezed as their short treasury positions moved against them. In order to mitigate their losses they reduced their leverage by selling long municipal bonds, but into a very weak market with few buyers – further exacerbating their losses. In addition, there were liquidations from investors who needed liquidity due to sub-prime mortgage losses. This selling weighed heavily on the municipal market in general as supply overwhelmed demand. High grade municipal bonds suffered along with lower rated issues due to these forced liquidations. In the last week of the month, yields had risen enough to bring back the demand for municipals, and yields fell sharply from their mid-month highs.

The taxable municipal bond market was also affected by the rise in yields in the municipal market, and yield spreads reached unprecedented levels at month end, despite a lack of new issue supply. Additionally, the Agency market also experienced a dislocation, particularly in short maturities as spreads widened dramatically in conjunction with widening swap spreads and higher Libor rates.

Breckinridge Strategy

We continue to hold our slightly longer duration strategy based on our outlook for a steeper yield curve (both municipal and Treasury curves) and expectation for Fed easing. In the tax-exempt portfolios we are focusing on the ten year part of the yield curve given how attractively valued they are after the recent back up in yields. Ten year municipal yields are currently trading at 90% of Treasuries – a level we haven't seen in almost two years, and that has previously occurred only six times since 1986. In past periods when munis reached these levels the relationship did not last very long and municipals out performed treasuries – a result that we expect to reoccur.



Source: Thomson Financial Municipal Yield
Federal Reserve Treasury Yield

Not only are 4.00%+ current tax-exempt yields in high grade intermediate municipals more attractive, but the taxable equivalent yields are now well over 6.00% for clients in higher tax brackets. We view the recent rise in yields as a very attractive buying opportunity. Within both the tax-exempt and taxable portfolios, we continue to take advantage of this buying opportunity by investing available cash or executing swaps where appropriate while avoiding riskier bonds should there be a resurgence of volatility.