

Monthly Review

More Negative News Spurs Fed Rate Cuts

Fallout from the housing crisis and the sub-prime mortgage/credit dislocation continued to dominate financial market sentiment during October. Each negative news item increased the pressure for another Federal Reserve rate cut. The Fed complied by cutting both the fed funds and discount rates by 25 basis points on October 31. However, they also moved to a neutral bias, stating the upside risks to inflation roughly balanced the downside risks to growth.

For the month, overall Treasury yields declined and municipal yields fell in all maturities, except in the 6- to 12-year range, where rates were unchanged.

Breckinridge Strategy

Maintaining Our Outlook for Lower Short and Intermediate Rates

We have not changed our strategy and continue to target durations that are slightly longer than our benchmarks' in anticipation of continued Fed easing, lower short and intermediate rates, and a steeper yield curve. Accordingly, our portfolios overweight the intermediate part of the yield curve.

We believe that the combination of higher commodity prices, a weaker dollar, and a 2008 increase in treasury supply will put pressure on long maturities next year. This should prevent longer rates from declining as much as shorter rates despite a slowing economy. We share the view of many analysts who expect the economic slowdown to significantly cut the rate of growth of tax receipts—both corporate and individual. At the same time, federal spending will likely grow at a faster pace causing the deficit to widen and treasury borrowing to increase.

In-State Muni Court Case Ruling Due by June 2008

A Supreme Court ruling on the Davis vs. Kentucky case, which relates to the tax-exempt status of in-state and out-of-state municipal bonds, is expected before June 2008. If the Supreme Court does not overturn the Kentucky court's decision, most of the municipal market segmentation by specialty tax states would disappear. The implications are significant, especially for yield relationships among states. We have written a detailed study of this case's potential impact on the municipal bond market, which can be found at www.bondinvestor.com in the "Special Commentary" section of our homepage. We will continue to monitor this situation closely.

2010 Tax Law Expiration Prompts Tax Reform Efforts

Tax-Exempt Muni Bonds to Remain Attractive

The current tax law is scheduled to expire in 2010, so the new President and Congress will tackle tax reform in 2009. All investors will feel the impact of whatever new law emerges.

Under the current law, as of January 1, 2011 there will be increases from:

- 35% to 39.6% for the top individual marginal tax rate
- 15% to 20% for the top statutory rate on capital gains
- 15% to 39.6% for the top rate on dividends
- 0% to 55% for the estate tax

We anticipate the Congress will try to prevent or modify some of these increases. It is also expected that the AMT will undergo reform or repeal.

The change in the administration and a potential change in Congress will probably have a meaningful impact on tax reform. House Ways and Means Committee Chairman Charles Rangel's recently introduced proposal provides a preview of Democratic reform. Key provisions include repealing the AMT and raising the tax rate on high income earners and corporations. The Democrats favor a more progressive tax on high income earners.

While it is difficult to predict the outcome of tax reform, it seems almost certain that the marginal tax rate for high income individuals will increase. This underscores the attractiveness of tax-exempt municipal bonds as investments.

Demographic Trend Favors Taxable Investing

Demand for safe, income-generating investments in individuals' IRAs will certainly increase as the 80 million baby boomers retire. With their high quality and attractive yield spread over treasuries, taxable municipals can provide similar income to high grade corporate bonds with lower historic default rates for taxable investors. They appear particularly attractive in an environment of declining credit quality in the corporate bond sector. Breckinridge believes that their high quality makes taxable municipal bonds well suited for IRAs, foundations or endowments.

We offer a taxable strategy for investors who wish to own individual securities within a professionally and separately managed fixed income account.

- The portfolios are diversified in taxable municipals, agencies and treasuries.
- The objective is to provide a very high quality, liquid portfolio that provides a stable income stream.
- With minimums and fees similar to our tax-free strategies, retirement accounts now represent more than one out of every three taxable dollars that Breckinridge manages: a trend that we expect to continue.