

Annual Review

Quality Reigned

Fixed income markets were volatile in 2007 with 10 Year Treasury Note yields trading in a range of 3.93% to 5.30%. The sub-prime mortgage crisis dominated the news and as the year progressed, it was revealed that the contagion had even spread to global financial markets. This resulted in a dislocation within the global credit markets that the Fed and other central banks could not ignore. The housing market continued to deteriorate, financial institutions incurred higher losses, and the availability of credit became more restrictive. Finally, beginning in September, the Fed stepped in and lowered the Fed Funds Rate initially by 50 basis points; followed by two more decreases of 25 basis points each. All indications are that the Fed will continue to lower rates in the near future in response to a weakening economy and tight credit conditions.

The prime beneficiary was U.S. Treasuries as investors fled to high quality assets, and yields declined substantially. Treasuries were closely followed by other high quality assets such as agencies and high quality municipals. Riskier assets were shunned in most sectors, such as lower quality investment grade bonds, anything related to the housing or finance sectors, lower quality municipal bonds (housing, hospital, and industrial revenue bonds), structured products, and high yield bonds.

Sub-prime Financial Contagion Impacts Municipal Market - Insurers Worries concerning bond insurers' exposure to sub-prime credit losses increased as the monoline insurers were faced with sharp scrutiny from the rating agencies. Fears of insurer's ratings downgrades to below AAA continue to plague the municipal bond market, and there has been a negative impact on the pricing of some insured bonds. A white paper on this subject can be viewed on our website, (www.bondinvestor.com).

Increasing Importance of Underlying Rating of Issuers

The concerns related to the bond insurers only served to underscore the importance of knowing and understanding the underlying credit of a municipal bond. Breckinridge's policy has always been to invest only in issuers whose underlying credit rating meets our strict parameters; and not to rely solely on the AAA rating derived from bond insurance. This is one of Breckinridge's basic tenets and it has served us well – particularly in this period of market uncertainty.

Fed Policy, Yield Curve and Market Outlook

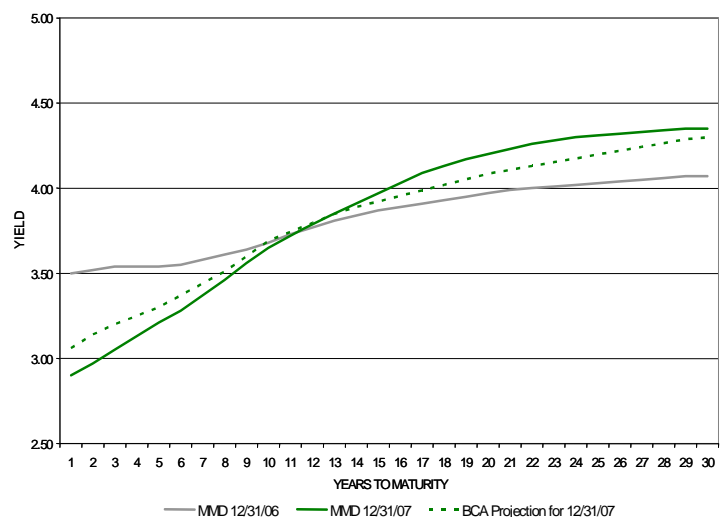
Restoring Market Liquidity and Confidence

In an attempt to restore liquidity to the banking sector the Federal Reserve recently instituted a new source of funding for banks and other financial institutions called a TAF (Term Auction Facility). This is a biweekly auction process in which banks are able to borrow from the Federal Reserve using more illiquid securities as collateral (certain mortgages and other securitized products, etc). The size of these auctions has increased as the extent of the problem has grown. Many analysts believe it will become an important tool the Federal Reserve will use in conducting monetary policy in addition to the lowering or raising of the Fed Funds and Discount Rates. It is hoped that this re-liquification of the global banking system will result in a decline in the Libor rate to a more normal spread relationship with U.S. short term rates. This would be an important catalyst for bank's willingness to lend, and should help to restore confidence to financial markets.

Yield Curve Steepening

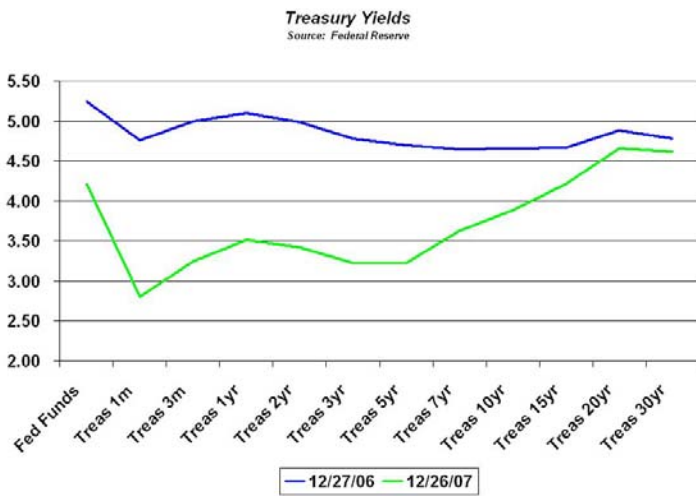
In 2007 the treasury yield curve steepened with short rates declining more than long rates. In contrast, while the municipal yield curve also steepened with short rates declining, long rates actually rose. The rise in long maturity municipal bond yields was primarily attributed to the unwinding of leveraged TOB/hedge funds. Looking forward, we expect to see further steepening of both treasury and municipal yield curves in response to future FOMC interest rate cuts. We believe short and intermediate rates will benefit the most from declining Fed Funds rates, and longer rates could rise due to continuing inflationary pressures. Stagflation fears are rising among economists and investors, and we share these fears.

MUNICIPAL YIELD CURVE CHANGE 2007



Source: MMD

TREASURY YIELD CURVE CHANGE 2007

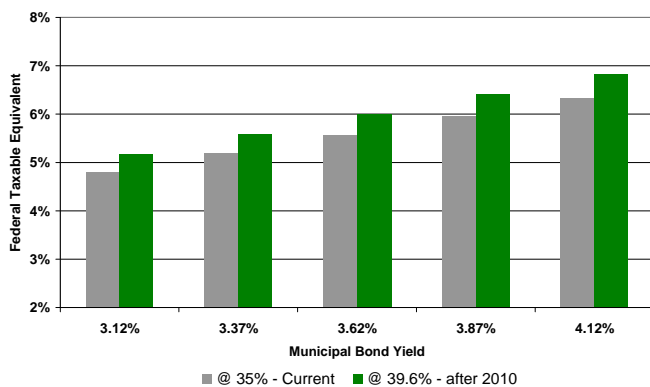


Source: Breckinridge

Taxation Changes

Relevant tax changes in 2007 were temporary relief from AMT, expiration of disaster relief tax credits and inflation increases in other credits and exemptions. However, the main tax stories for the year were the expiration of the Bush tax cuts and the Davis vs. Kentucky case before the Supreme Court. All provisions of the Bush tax policy have been extended to expire at the end of 2010 including the 35% maximum rate rising to 39.6% and dividends and capital gains rates reverting to ordinary income and 28%, respectively. The impact would make municipal bonds significantly more attractive relative to taxable investments. The Davis vs. Kentucky case involves the in-state bond exemption for state income tax when out-of-state bonds are taxed. The Supreme Court heard the case in November 2007. A decision is expected in the first six months of 2008. There is a white paper with more detail on the case on our website, (www.bondinvestor.com)

MUNICIPAL TAXABLE EQUIVALENT YIELDS



Source: Breckinridge

Breckinridge Strategy

We continue to focus our strategy on a more bulleted intermediate maturity portfolio structure in anticipation of a steeper yield curve. As mentioned in our last newsletter, we have slightly decreased the duration target, moving closer to the benchmark due to the factors listed above. Our emphasis on highly rated (underlying rating) securities remains constant.

Breckinridge Philosophy Affirmed

This was a difficult year for many fixed income investors as the benefit for taking risk (which had been rewarded for the past several years) disappeared. Risk aversion became the watchword, and investing in high quality, intermediate maturity bonds was well compensated. Breckinridge's philosophy has always been centered on the management of high quality fixed income portfolios. This uncompromising standard served our clients well in 2007.