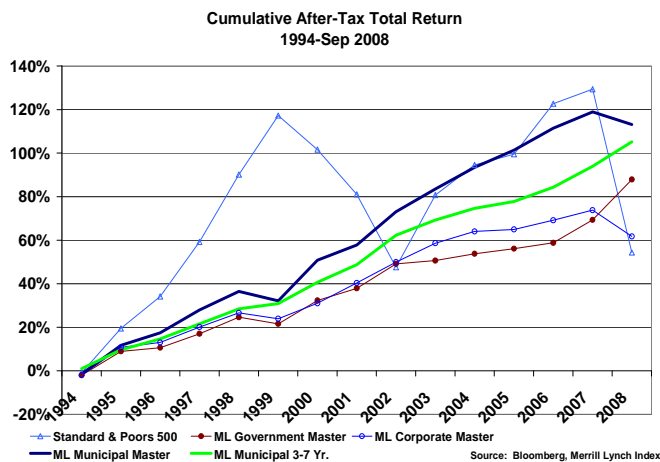
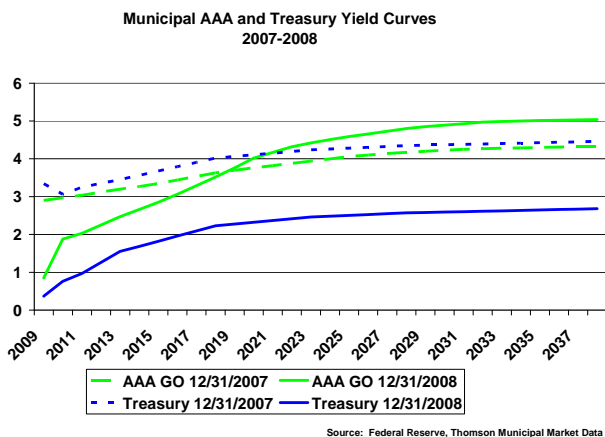


Market Review

2008 will be remembered as a year of two extremes in the capital markets. Massive financial deleveraging caused some markets to freeze or even collapse, further exacerbating the decline in the economy. The result was dismal equity and high yield returns, and an acute aversion to risk. At the same time, the subsequent flight to quality produced outsized treasury returns and exceedingly low yields. Despite these extremes, certain higher quality fixed income sectors proved to be a solid middle ground, posting returns in the mid single digits. In particular, high grade intermediate municipal bonds performed well in a tumultuous market.



As seen in the chart below, while treasury yields declined to historic lows, municipal yields with maturities of 10 years or more actually rose in response to events unique to the municipal bond market. Factors that negatively affected the municipal market were: deleveraging in long maturities, high yield bond funds (outflows); the collapse of the Auction Rate market; downgrades of the monoline insurers; and the demise of several major underwriters. The result was greatly impaired liquidity and higher yields.



Long maturity, high yield municipal bond funds experienced large redemptions and were forced to sell into a market with no buyers and more importantly, no support from dealers. This was especially evident in the fourth quarter as illiquidity and volatility increased. Reflecting the volatility in the municipal market, the yield on the ten-year maturity AAA General Obligation bonds ranged from 4.86% to 3.52% during the fourth quarter alone.

In a flight to quality, retail investors favored Pre-refunded bonds, municipal bonds that are backed by U.S. Treasury securities. The demand for Pre-refunded bonds far outstripped the supply, and yields on these high quality bonds have declined to unprecedented levels.

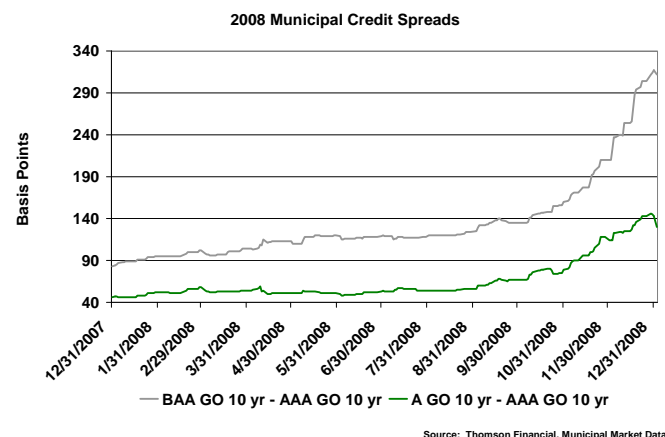
Breckinridge Strategy

The Pendulum Swings Too Far

Breckinridge believes that the flight to quality has become overdone. As this is being written, we are already seeing a reversal of the flight to U.S. Treasuries with a yield back-up of over 30 basis points in the thirty-year Treasury bond in the first few days of the New Year. State and local municipalities face great challenges as their budget gaps increase in this weak economy. However, we believe many opportunities exist within the municipal bond market as solid credits have been wrongly perceived. (See Special Commentary Section)

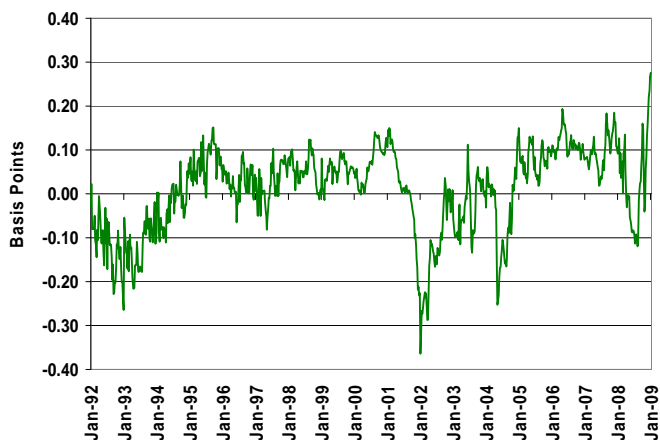
Tax-Exempt Strategy

The municipal market turmoil has caused the retail market to shy away from any perceived risk, even in high quality general obligation and essential purpose bonds. Quality spreads widened over the last quarter of 2008. There are good bonds at very attractive yields but credit work is needed to identify the wheat from the chaff. The danger in buying A-rated credits is the sharp increase in spreads if the bond is downgraded, so we review all potential trades. While maintaining our standard for quality we have selectively been adding more A-rated general obligation and essential service issues.



We continue to move toward a more barbelled structure in portfolios, buying 1-2 year maturities to offset 11-13 year maturities to replicate the duration of the five-year bond in anticipation of an eventual flattening of the yield curve. This opportunity is more attractive as the municipal yield curve is very steep compared to the Treasury curve (see the yield curve charts above). In a somewhat unusual circumstance, the barbelled portfolio currently has a higher average yield than the five-year bullet. Usually, a barbell will reduce the yield on the portfolio because the yields tend to rise steeply from one to five years and level off after five years. Currently, the steepest part of the yield curve is in maturities between eleven and thirteen years.

Yield Spread: Barbell to Bullet



Taxable Strategy

While Treasuries far outperformed all other taxable fixed income sectors, other high quality sectors performed well in the flight to quality in 2008. Returns were commensurate with quality, with agencies, taxable municipals, mortgages, and select corporates posting returns in the mid to high single digits. Government support of agency debt under conservatorship and the TARP program resulted in rapid and significant spread tightening in the fourth quarter. Taxable municipals performed well as they benefited from low supply and high credit quality.

We continue to focus on high quality taxable municipals which remain at yield spreads that are both historically high, and relative to other sectors, very attractive. While agency debt has tightened substantially from the wide pre-TARP levels, we believe they are still attractive on an historical basis. In addition, within certain mandates, we purchased the newly issued FDIC insured TLGP bank debt; and are finding select opportunities in the high grade intermediate corporate bond sector.

Special Commentary

Municipal Credit Opportunities

The extreme dislocation that has occurred in the municipal bond market has produced opportunities for the discerning investor. Individual credits, as well as whole sectors are trading at what we believe are unrealistic levels. We see opportunity in single-A rated general obligation bonds which have become relatively inexpensive compared to AA-Rated credits in the same sector.

As expected, A-rated municipalities have credit characteristics that are modestly less robust than higher-rated borrowers yet still share the same strong security: the issuer's full faith and credit and taxing power. One way to compare A and AA credits is to look at Moody's local government medians for a number of financial and demographic factors. For example, among smaller cities (population less than 50,000), many median indicators are markedly similar: single-A issuers' unreserved general fund balances average 25% of expenditures compared to 26% for the higher-rated credits, while the median debt load for the latter amounts to 2.4% of full value vs. 1.9% for AA-rated borrowers. The primary differences between the two quality levels are wealth parameters: median property value per capita and per capita income for AA-rated issuers are \$148,000 and \$32,000, respectively, compared to \$84,000 and \$23,000 for single-A towns. *

Given the nearly spotless default record in the municipal bond market's general obligation/essential service sector, these statistics indicate that selective value remains in the A-rated segment, especially at recent spread levels. To be sure, cities and towns will face declining revenues and falling state aid that will stress budgets and force municipalities to make difficult expenditure cuts; some credits will face rating actions and possible downgrades. However, along with the pledge to raise taxes to meet debt service, many mid-investment grade credits share modest debt loads, good fund balances and sound management practices. With careful analysis of financial, economic and budgeting factors, A-rated general obligations can add incremental yield to a portfolio without appreciably changing its risk profile.

* Source: Moody's