

Market Overview

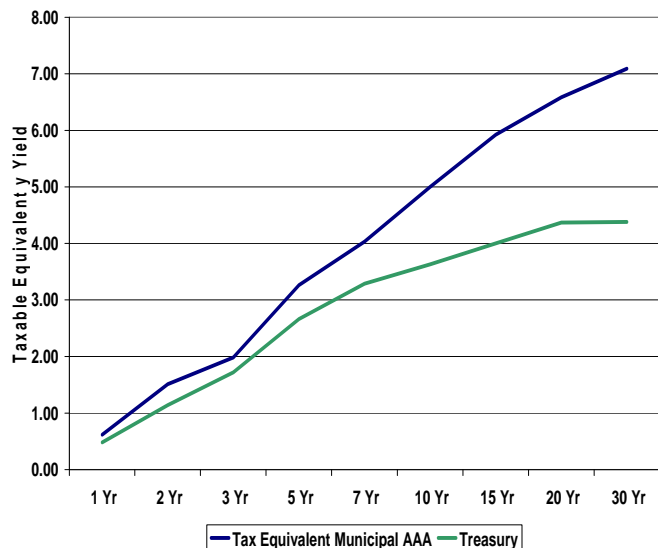
Risk Appetite Returned

Treasury yields rose during the quarter with intermediate maturities, five to 10 years, rising more than short or long maturities. This was primarily due to two factors. Some of the economic data released during the quarter showed signs of stabilization, which led many investors to believe that a recovery (and higher inflation) was not far off. Based on this change in sentiment the equity market rallied, Treasuries sold off, and yields rose. In early June, the 10-year Treasury note reached almost 4.00 percent. Additionally, Treasury yields were pressured by the increase in government borrowing. The massive increase in Treasury supply contributed to the sell-off in the Treasury market as investors demanded higher yields.

At the same time, risk appetite returned to the markets, and lower quality bonds outperformed higher quality bonds in both the taxable and tax-exempt markets. Treasuries were the worst performers with long-maturity Treasuries declining more than 11 percent in the quarter. In the taxable market, corporate bonds outperformed all other sectors.

Tax-exempt bonds posted positive returns with long maturities doing particularly well. This reflected decreased supply of long-maturity, tax-exempt municipal bonds. As we discuss later, long-maturity, tax-exempt municipals have benefitted and should continue to benefit from the issuance of long-maturity, taxable municipal bonds under the Build America Bond program.

Yield Curve Comparison



Source: Treasury Yields from the Federal Reserve Weekly Interest Rate Report; Municipal Yields from Thomson Financial AAA GO Curve adjusted for a 35% marginal tax rate.

Tax-Exempt Strategy

Favorable Supply/Demand Outlook

Though lower than at the start of the year, tax-free municipal yields are still attractive versus taxable bonds, especially Treasuries. Consequently, investor demand remains strong, though tempered somewhat by concerns about credit quality. Municipal bond funds continue to report very strong inflows (except for California). In addition, there is a growing appetite among institutional investors for taxable Build America Bonds. This means a significant portion of municipal bond supply is likely to be directed to the taxable bond market. As a result, tax-free supply will likely tighten. Taken together, the solid demand and limited supply should positively impact municipal bond performance. Therefore, our strategy at Breckinridge continues to be to maintain a slightly longer portfolio duration versus our benchmarks. This has been achieved by opportunistically adding exposure to the eight- to 12-year maturity range. The overweight in this maturity range is then offset with short-term bonds producing a relatively barbelled structure. Given the steepness of the yield curve, we believe this barbelled structure will provide the best risk-adjusted return

Taxable Strategy

Interest Rate Outlook Uncertain

We expect the Treasury market to continue to be affected by the crosscurrents of an economy that is struggling to recover and a significant rise in government borrowing. For this reason we expect yields to remain range-bound until a clear trend emerges. We are targeting a fairly neutral duration to the benchmark with an emphasis on yield. We also continue to target a barbelled structure in the portfolios given the uncertainty of the direction of interest rates.

Taxable municipal bonds performed well relative to Treasuries and Agencies during the quarter, as did corporate bonds. We continue to overweight high quality taxable municipals given the relative attractiveness of the yields.

Taxable Municipals Provide Needed Market Balance

Long-duration, high-quality BABs broaden demand

Since their creation in February as part of the American Recovery and Reinvestment Act of 2009, Build America Bonds have broadened demand for municipal bonds and stabilized the overall municipal bond market. BABs are taxable bonds that municipalities can issue for capital projects and receive a 35 percent subsidy payment from the government to reduce borrowing costs.

Why have BABs had such a big impact? The BAB program fills a critical void left by the undoing of the Variable Rate Demand Note market in the financial crisis.

Before last year's financial meltdown, VRDNs were the primary short-term financing structures used to reconcile municipalities' desire to issue long-term bonds to finance long-term capital projects with individual investors' desire to hold short-term bonds. However, a key element of VRDNs is the liquidity backstop provided by a highly rated bank or financial institution. After experiencing overwhelming redemptions in fall 2008, banks now are determined to limit further exposure to VRDNs. With liquidity facilities now less available, the VRDN market has contracted dramatically. The result has been an imbalance in supply and demand, with excess supply in the long-end of the municipal market.

The federal government created the BAB program within the fiscal stimulus legislation to address the high cost of borrowing for municipalities caused by this imbalance. The long duration and high quality of BABs is very appealing to taxable fixed income investors such as insurance companies, endowments and pension funds, which has broadened demand and helped stabilize the municipal bond market. Although set to expire year-end 2010, we have every expectation given its positive impact to-date that the BAB program will be extended or broadened.

Taking Advantage of Taxable Municipals

When indicated by compelling after-tax returns

One possible implication of the growing depth and acceptance of the taxable municipal market is a shift in supply to taxable debt from tax-free debt. If there is a meaningful reduction in the supply of tax-free debt, then tax-free yields may decline to the point where compelling after-tax returns for certain clients may be more readily available in taxable municipal bonds. This is especially likely for investors in lower tax brackets.

Breckinridge continues to enhance its ability to take advantage of taxable municipals for specific clients when analysis indicates compelling after-tax returns are available.

First, we are reviewing our statements of investment policy and objectives for each account to ensure taxable municipal bonds are eligible for purchase. While we have always had the ability in our portfolios to purchase taxable bonds should after-tax yields warrant, this allocation has been used sparingly and limited to treasury and agency securities. We believe the emergence of the successful BAB program warrants expanding this capability to include high-grade, traditional-sector taxable municipals.

Second, we have made enhancements to our portfolio management system so that we may utilize actual investor marginal tax rates to refine our security selection process. Reinvestment and swap decisions will be made based on the most recent tax information available to Breckinridge. At a minimum, investor tax information will be updated annually. Additionally, advisors are encouraged to notify Breckinridge whenever there is a significant change in a client's tax status.

While these enhancements will strengthen our ability to maximize after-tax returns over the long term, we do not anticipate they will produce immediate changes to most client portfolios. For example in the majority of cases:

Clients will not see an immediate allocation made to taxable municipals as tax-free bonds currently offer superior after-tax returns. With marginal tax rates at the federal level expected to increase, this advantage is likely to remain for many clients even in the event of a supply shift to taxable municipals.

Portfolio turnover will not change. Our portfolio management strategy remains focused on tax efficiency and maximizing after-tax returns, which are negatively impacted by excessive trading. The decision to allocate to taxable or tax-free municipals will be made as part of a reinvestment or swap decision. These normal management decisions typically result in annual portfolio turnover of about 25 percent.

There is no additional credit risk. Taxable municipal issues have the same security as their tax-free counterparts.

We are in the process of reaching out to consultants to discuss the merits and mechanics of these enhancements. However, we encourage those with interest or questions about taxable municipals to contact us at their convenience.