Tax Efficient Fixed Income

1st Quarter 2007 Review and Outlook

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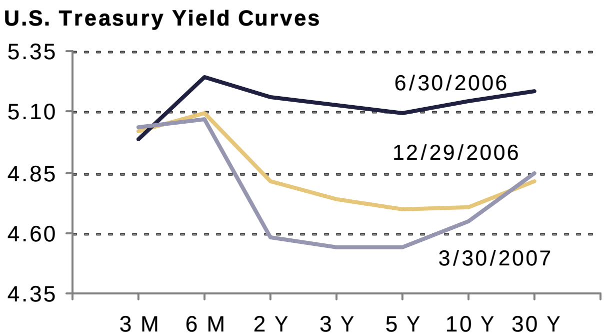
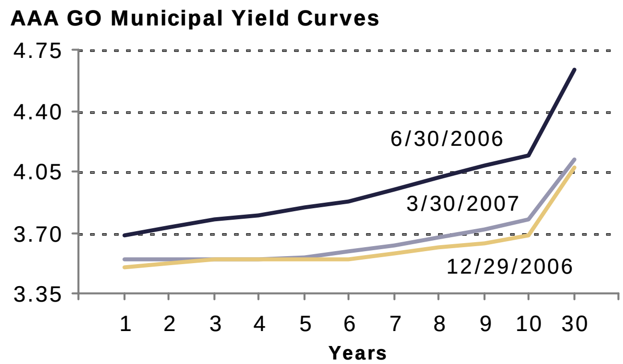
The stalemate in the fixed income markets continued during the first quarter, with a resolute Federal Reserve holding short rates at 5.25%, while foreign buyers and investors expecting lower inflation and softer economic growth held bond yields much lower. Corporate and municipal borrowers rushed to the market in record volume, while investors bought with abandon. Treasury and municipal yields are close to year-end levels. Furthermore, 5, 7, 10, and 30-year municipal yields are almost exactly unchanged from year-end, although they remain well below the levels of last June when the Federal Reserve last raised the Fed Funds rate.





As you know from our recent commentaries, we have held the duration of portfolios shorter than those of the indices and shorter than our long term strategic norm. We concentrated holdings in the 3-5 year area – the best performing part of the bond market during the quarter. The result to date has been a slightly higher return with less risk. With little additional yield offered by longer bonds; with the economy growing moderately; and with inflation stuck above the Fed's comfort zone; we plan to continue this approach into the second quarter. In doing so, we recognize there is a possibility of holding too few longer-dated bonds if the economy slows further. However, we believe that the recent slowdown in the economy is already reflected in the inverted yield curve. An increase in economic activity and/or inflation could the make the yield curve susceptible to a steepening.

The Fed's last minutes of March 21st noted their expectations of a moderately growing economy – the housing retrenchment notwithstanding – and their "predominant policy concern … [is] that inflation will fail to moderate as expected." Their concern, in our opinion, is well placed. The "high level of resource utilization" behind that policy concern is underscored by the strong March employment report and strong commodities markets. The global economy will continue to be supported by a firm jobs market in the United States, by stimulative global fiscal and monetary policies, and by strong economies overseas. A condition where 90-day Treasury Bills yield 5.25% and ten-year Treasury notes yield 4.65% could be viewed as unsustainable. When investors realize that the firm economy will underpin the short rate, longer rates may rise. At that point we believe there will be plenty of liquidity with which to buy longer bonds.

Municipals remain the most attractive fixed income sector for taxpaying investors in short-intermediate to long term maturities. The ratio of municipal yields to Treasury yields, a common measure of relative value, indicates that tax free bonds are more attractive than taxable bonds. Municipal yields in the 3 to 5-year sector are currently around 78% of Treasury yields, which compares favorably to the average of 74-76% over the last two years. We expect this relationship to remain relatively stable as long as yield curves in the US remain relatively flat or inverted. Unlike the inverted US Treasury yield curve, the municipal yield curve is still positively sloped, so the advantage of municipals versus Treasuries increases as maturity increases. While the municipal yield curve is extraordinarily flat by historical standards, it is unlikely to truly invert due to factors unique to the municipal bond market and municipals will remain the preferred sector for taxpaying clients as long as this relationship persists.

For tax-exempt investors, such as not for profit entities, the lower yields in the 3-5 year area of the market were key to a strong quarter. Enhancing returns further were the outperformance of TIPS, and taxable municipals, as well as the underweighting of mortgaged-backed securities.

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