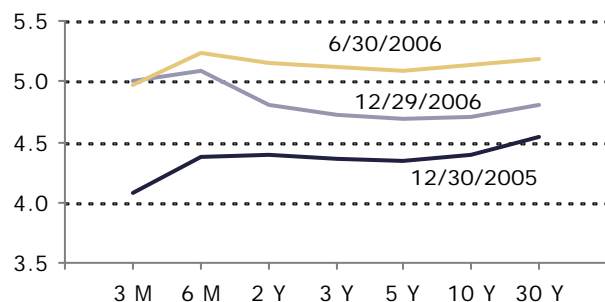


Tax Efficient Fixed Income

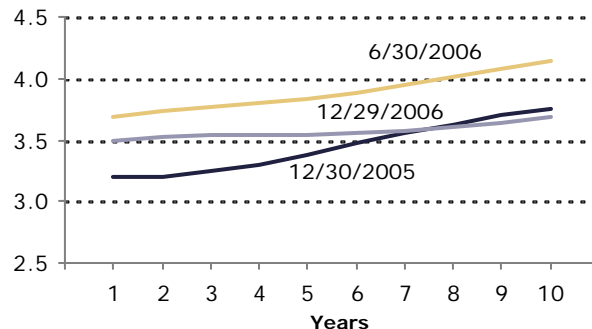
4th Quarter 2006 Review and Outlook

In 2006, bonds produced their best returns in three years, as the Lehman 5 Year Municipal Index came in at 3.34% for the year and the Lehman Intermediate Aggregate Index returned 4.58%. The gains in the bond market were broad based, but grew with the risk characteristics of the class. High yield corporates and emerging markets bonds continued a four-year run of outsized returns – as did stocks – and the Treasury market lagged. Treasuries were the only sector to suffer principal declines across the yield curve.

U.S. Treasury Yield Curves



AAA GO Municipal Yield Curves



Bond yields, as measured by the five-year Treasury note, almost executed a round trip, rising from about 4.25% to 5.25% in the first half of the year, and then falling below 4.40% in December before finishing 2006 at 4.65%. Assessments of economic growth made that same trip – as did major commodity indices – and finished the year in deep ambivalence. Some analysts point to weaker housing, softening manufacturing, and continued geopolitical turmoil as catalysts for inevitable economic decline in 2007, while others point to a resilient consumer, strong job growth, and strong international markets as signs of a rebounding economy. After its December policy meeting, the Federal Reserve seemed to fall in the middle: “Although recent indicators have been mixed, the economy seems likely to expand at a moderate pace on balance over coming quarters.”

You may recall from our second-quarter review that “*we may lengthen portfolios beyond our current neutral stance to benefit from higher yields. Although the time is not yet right, our decision to lengthen the maturity structure may very well come at a time when Treasury short rates are the same or even higher than longer rates, and municipal and corporate yield curves flatten further.*” With hindsight, we should have been more aggressive, but we are convinced that the subsequent decline in yields has carried bonds to unattractive levels. While the Federal Reserve has little cause to raise the overnight rate above its present level of 5¼%, it does not have to act further to make a 4.7% 5 or 10 year yield unappealing, as the market has fully discounted an easier monetary policy.

For that reason, our portfolios enter the new year in a defensive posture. Throughout 2006 Samson sought to position portfolios more defensively through a number of key strategic changes: portfolio structures were moved from a barbell to a bullet yield curve strategy; credit quality of portfolios was increased by emphasizing prerefunded securities and deemphasizing general obligation bonds and revenue bonds; allocations to taxable securities were utilized when appropriate to enhance after-tax income and total return; and call structures of the securities we considered for purchase were analyzed to ensure they were consistent with the internally developed scenarios we utilize as part of our planning process.

Through most of the year the municipal market outperformed taxable bonds despite a declining federal income tax bite. This contradicts intuition, but was perhaps due to declining supply of new municipal issues; the large and growing influence of hedge funds; a sharp improvement in municipal credit quality; and a large increase in the nation’s personal wealth. Housing sales and requests for building permits declined throughout

much of 2006 and the drop accelerated in the second half of the year. The concerns about the housing market caused taxable rates to fall, and municipals cheapened considerably vs. their taxable counterparts. In this environment, we emphasized municipals both for their relative attractiveness and due to their low beta relationship to taxable bonds in a rising rate environment. Interestingly, at the time we were reducing exposures to taxables, we were also moving our duration posture down to 95% from 100% of benchmark.

There are ample signs that the second-half decline in interest rates is sowing the seeds of its own reversal. Residential housing sales showed a small bounce in the fourth quarter, while the cheap and ready supply of credit is contributing to the strong returns among risk assets, and is financing the surge in private equity and merger activity and commercial real estate development. The world-wide search for higher returns ensures that no economic project will lapse for lack of financing. The globalization of credit also reduces the impact of the Fed's 17-stage credit tightening and mutes the impact of the inverted curve. As a result, we expect the economy to rebound and for bonds to start the year on the defensive.

January 19, 2007

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