

Tax Efficient Fixed Income

2nd Quarter 2006 Review and Outlook

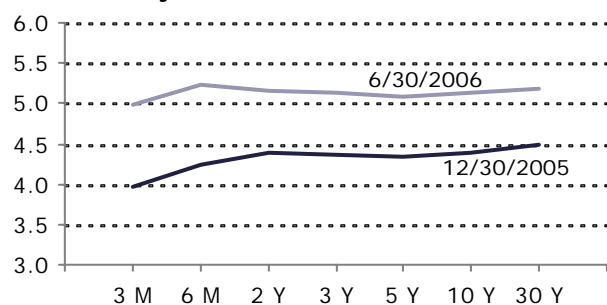
The lackluster returns in the second quarter from most asset classes are a reflection of divergent economic indicators. On one side of the argument is the concern that the economy is slowing, a concern based on evidence of a weaker housing market, higher energy prices, and slowing retail sales. This concern led to marked contractions in global equity prices this past spring. Of equal importance is the concern about rising inflation brought on by demand from emerging nations and by strained resources typical at this stage of the business cycle. The Federal Reserve, of course, is caught in the middle, and it will fall to the Governors to determine what level of interest rates will be necessary to stem inflation and achieve a soft landing for the economy.

We now believe that short and intermediate interest rates are fairly valued. Consequently, we have incrementally lengthened portfolio average durations to be in line with that of market indices. As we continue to believe that the risk-return relationship is unfavorable for longer maturities, our purchases have been focused in the four to seven year part of the curve. This is in line with our bulleted yield curve strategy, which is based on our belief that, although there may be additional Fed tightening, most of the curve flattening has already taken place.

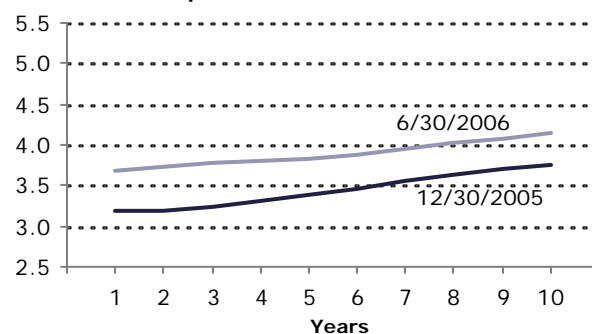
A decline in municipal bond issuance has supported the bid for municipal bonds, causing them to outperform taxable securities. New issuance of municipal bonds declined by 14% to \$180 billion in the first six months of 2006, as compared to \$209 billion in the first six months of 2005. The drop – in contrast to trends in the corporate and U.S. Treasury markets – was due to a dramatic decline in refundings, as most issuers took advantage of historically low interest rates to refund their outstanding debt within the limits of regulations over the last several years. Also, the credit quality of most states, cities, and other issuers has improved as a result of the economic recovery, reducing their need to borrow for budget purposes. Finally, in this calendar year, issuers are selling a greater percentage of variable rate versus traditional fixed rate notes and bonds.

At some point in the future, 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. These yield curve movements would usually occur in anticipation of a decline in global economic activity, and an expectation of lower inflation. A future portfolio extension may also take place if our analysis shows bond yields to be at levels that compensate investors for credit and duration risk.

U.S. Treasury Yield Curves



AAA GO Municipal Yield Curves



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