

# Tax Efficient Fixed Income

## 2<sup>nd</sup> Quarter 2005 Review and Outlook

Our earlier Market Commentaries have observed that the existing interest rate structure in the bond market is not consistent with a growing economy, unrelenting tightening by the Federal Reserve, record trade and budget deficits, the prospect of a lengthening military commitment overseas, an overheated housing market, and rising commodities prices. Accordingly, we have maintained a modestly defensive duration posture with respect to bond investments in our portfolios. Those issues notwithstanding, the second quarter brought a shift in the psychology of bond market participants. Although the expectations for continued economic growth remain, the expectations of sharply higher interest rates have waned dramatically.

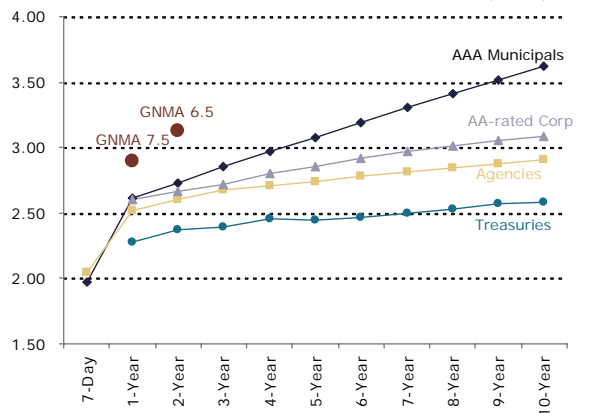
Recently, there have been some attempts to back into an explanation for the fall in longer rates, including the sudden discovery of the global savings excess and, indeed, there are signs that the economies of Europe and Asia are slowing. The effect of this shift was a downturn in intermediate and longer-dated bond yields, even as short-dated rates continued to climb.

The performance of Samson portfolios kept pace with the market despite its defensive posture because we had added some longer-dated bonds while keeping the average portfolio durations shorter than the benchmark duration. We plan to maintain that posture over the near future.

The bond market, at the low end of the year-long trading range, remains overvalued, with minimal premium to protect against inflation, volatility or credit risk. We expect the Fed to continue to increase short term rates and that the current resistance of long rates to the Fed medicine is likely to end. As Fed Funds rise from here, sub-four percent bond yields should give way.

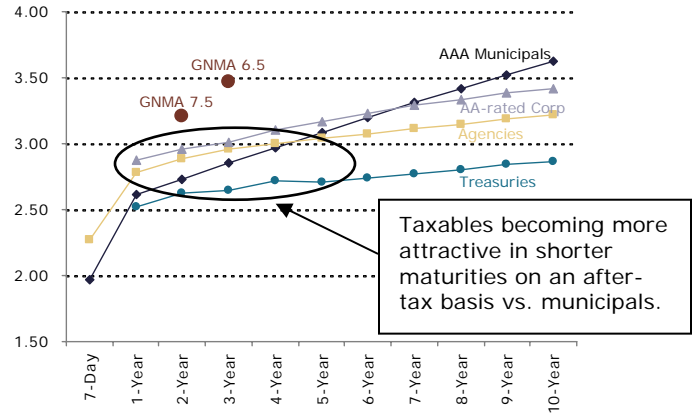
At quarter-end, municipals remained attractively priced when compared to taxable issues, so much so that we even favored them for clients subject to the alternative minimum tax. However, as noted in the chart below, municipals have outperformed taxables in the first part of July. As these after-tax relationships become more attractive we may consider allocations to taxable sectors where appropriate.

**After-Tax Yield Curve at Max Federal Tax Rate (35%)**



	2-year	3-year	5-year	10-year
AAA Municipals	2.73	2.85	3.08	3.62
Agencies	2.61	2.67	2.74	2.91
AA Corp	2.67	2.72	2.86	3.08
Treasuries	2.37	2.39	2.44	2.58
GNMA	2.89	3.13		

**After-Tax Yield Curve at AMT Rate (28%)**



	2-year	3-year	5-year	10-year
AAA Municipals	2.73	2.85	3.08	3.62
Agencies	2.89	2.96	3.04	3.22
AA Corp	2.96	3.01	3.17	3.42
Treasuries	2.63	2.65	2.71	2.86
GNMA	3.20	3.47		

Source: Bloomberg  
As of 7/12/05

From a credit standpoint, state and local issues have benefited from four years of economic growth, as tax receipts have rebounded and social costs receded. Of special note was the upgrade of New York City to A1/A+, that city's highest bond rating since the end of World War II.

The terrorist attack on London in early July reminds us of the clear benefits of an allocation to fixed income. We will keep portfolios fully invested, despite the low yields, and look for opportunities to extend duration when rates rise.

*There is no guarantee that the forecasts and opinions expressed in this article will be realized. The statements in this article are opinions only and are not guarantees or projections of future performance.*