Fed Watch

We closed the second quarter with the Federal Reserve hiking its target for the Federal Funds Rate by another quarter point to 3.25%, making it the 9th consecutive increase since June 2004. Providing further justification for the Federal Reserve's continued tightening campaign, Chairman Greenspan testified that "With underlying inflation expected to be contained, the committee believes that policy accommodation can be removed at a pace that is likely to be measured." Normally, as the Federal Reserve adjusts short-term interest rates upward, the market makes a similar upward adjustment to the rate charged for longer-term borrowing. This tightening cycle however has been incredibly different. Against a backdrop of a rising Federal Funds Rate, we have witnessed atypical price movements, as Treasury bond yields declined significantly across the maturity spectrum. Since the Fed started to raise rates, the yield on the 10-year note has declined from 4.85% to 3.92% over the last year.

Impact to Consumer Spending

With a 225 basis point increase in the funds rate over a one year period, one could expect consumer spending to be constrained. While this might be a reasonable expectation, consumers are still spending freely. Home owner's adjustable rate mortgage expenses have elevated due to the rise in short term interest rates; these consumers are collectively in a solid financial position as a declining 10-year note yield has cheapened the cost of fixed rate mortgages. In fact, swelling home valuations and rising household earnings have served to counter the negative economic impact of higher fuel and other commodity prices.

Conundrum?

This interesting dynamic of declining long term interest rates, coincident with increasing short term rates was first mentioned by Greenspan in February 2005 and dubbed by him as a "conundrum." We, on the other hand, do not approach this event with confusion. We find the Chairman's conundrum comments to be remarkable, since he has simultaneously pushed up the Federal Funds Rate by 225 basis points and testified that the underlying inflation rate is expected to be contained. Can these two dynamics have any other impact than to flatten the yield curve? Given the world-wide search for yield, this dynamic is less surprising to us than it is to the Chairman. Greenspan has been concerned about asset price inflation, particularly with the "froth" in real estate prices. There is also trepidation on his behalf with respect to financing vehicles that are being utilized to fund real estate purchases. For example, Interest Only (IO's) and Adjustable Rate Mortgages (ARM's) have become increasingly more fashionable methods for individuals to borrow money.

Hedge Funds

We believe that the Federal Reserve, while trying to ensure that the rate of inflation is contained, is clearly intent on raising short term interest rates so that the appeal of leveraged investments is reduced. According to the Investment Company institute, total hedge fund assets now top $1 trillion. With most of these entities routinely engaging in leveraged trading strategies, a higher cost of financing should serve to diminish their incentive to employ funding strategies and possibly reduce the number of opportunities that are available to exploit. Given the regulators' confusion and fear of hedge funds, it is not surprising that the Chairman might want the growth of these products to slow. Looked at from a different angle, it would be quite unlikely for the Federal Reserve to openly state that a part of their policy decision is predicated on combating specific trading strategies and asset price inflation.

Municipal bond Market Overview

Sparked by a strong Treasury bond market rally, Municipal Bonds turned in an impressive second quarter performance. The Lehman Brothers Municipal Bond Index, which we use as a proxy for market returns, jumped 2.93%. Most of the market action was concentrated in longer maturity debt causing the yield curve to continue its flattening trend. Tax-exempt yields declining 28 basis points on securities maturing in 15 years, compared to 2 year maturities, which fell by only 8 basis points. A massive amount of refunding activity helped to drive the overall level of new issuance to record levels. For the first half of 2005, $206.32 billion in bonds was priced compared to the 2003 record of $205.85 billion.

Reinvestment season

Traditionally, the month of July scores the highest total rates of return on the back of light new-issue supply and increased demand. This period, known as the “July effect”, will put roughly $ 41 billion back into investor’s hands this year by way of bond calls, maturing securities, and coupon income. This increase in cash flow will become available for reinvesting in the Municipal Bond market when issuers of debt are typically on hiatus. In terms of total rates of return, this market dynamic has contributed to July being one of the strongest months. Since 1990, the average return for July was 99 basis points, second only to December, where the average monthly return was 101 basis points.

Relative performance

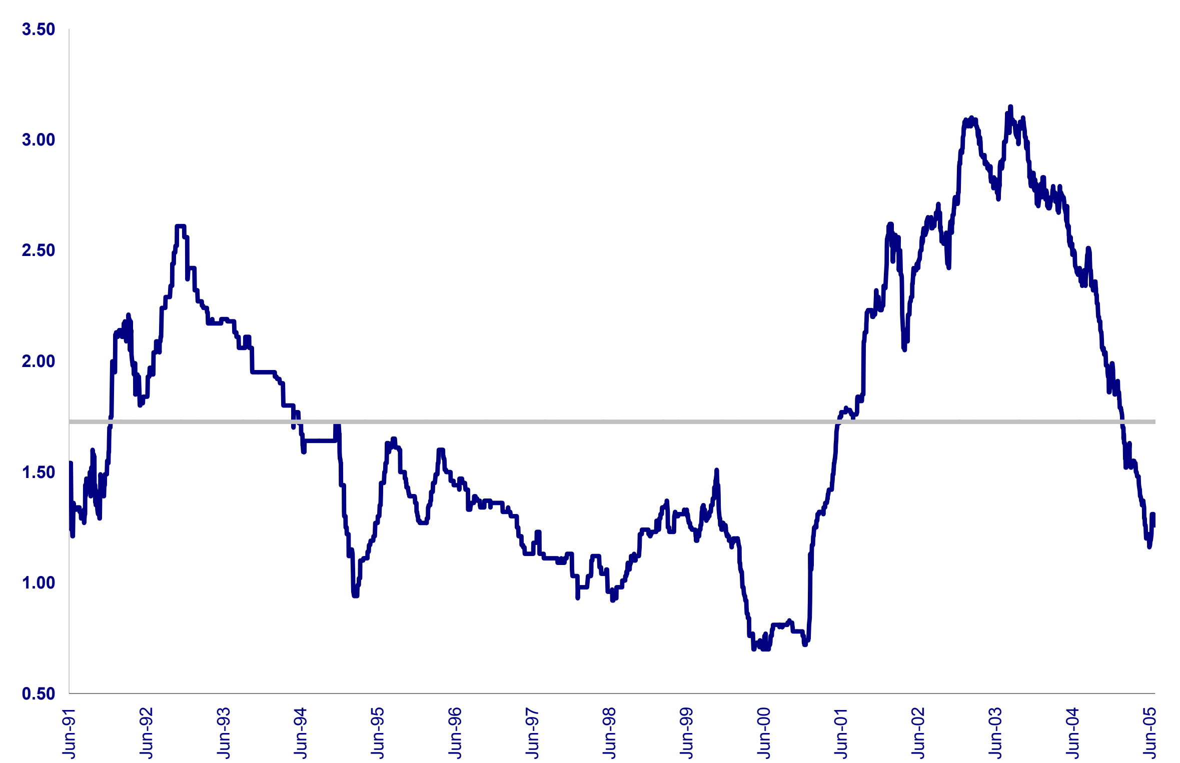
Typically, as Treasury bond prices appreciate rapidly, municipal bond prices react slower; thus, from a total rate of return perspective - they under perform. The supply/demand imbalance, which is created by falling interest rates, is a dominant reason for this. Lower market rates afford municipal issuers an ability to retire outstanding, higher coupon debt at specified call dates as well as re-issue new, lower yielding bonds. Normally, the increase in new issue supply is met with weaker demand, while lower market yields serve to cool demand. With the level of new issuance exceeding investor demand, the ratio of municipal bond yields relative to treasury bonds tends to rise. For example, 15 year tax-exempt securities are currently offered at 95.5% of Treasury bonds.

Fortunately for municipal investors, there are forces at work which have precluded this ratio from reaching levels that exceed 100% by a wide margin. This stems from the fact that the tax-exempt market derives a benefit from appearing attractive relative to Treasury securities. At higher relative percentages, the audience for municipal bonds is broadened, as cross-over accounts (those who are traditionally taxable bond investors) and the arbitrage community step in to exploit opportunities in the asset class. It is estimated that $200 billion of municipal bonds is controlled on a leveraged basis. (MMA) This significant involvement of these flexible accounts has caused a dichotomy of price versus transaction size. For example, we are currently witnessing a two tiered price environment within the secondary market, whereby investors, accumulating blocks of $5 million or more, are paying prices that are ½% to 1% point higher then managers acquiring smaller lots (i.e. $1,000M).

Strategy

We believe that relying on interest rate forecasting to enhance returns is a risky and precarious proposition. Instead, we rely on research focused in several areas, which include: yield curve, coupon, and horizon analysis in order to determine the most optimal portfolio structure, while maximizing our clients' after-tax total rate of return. With respect to our yield curve positioning, we entered the quarter with a strong bias toward emphasizing the 12 to 18 year region of the yield curve. While this area should still enjoy solid returns per unit of risk, we believe that the potential reward of holding a sizeable overweight to the 15 year section has diminished. As the yield curve has flattened dramatically, a more cautious approach is now warranted.

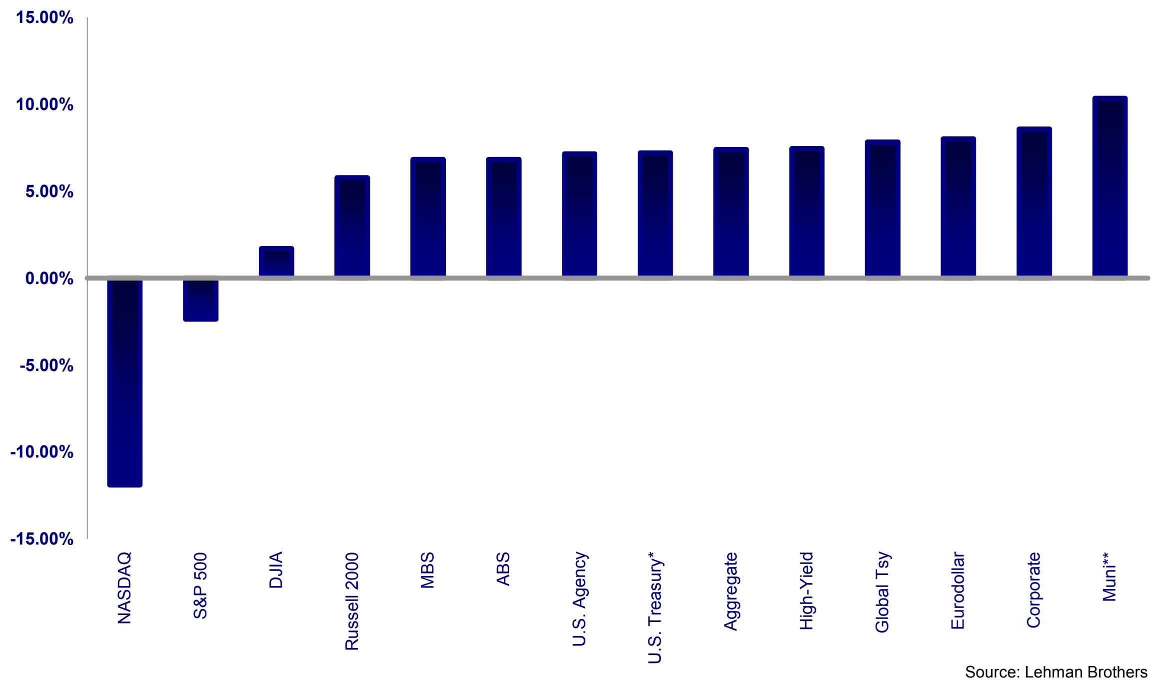
2 Year / 15 Year AAA Municipal Bond Spreads



Source: Bloomberg, RSW Investments

At quarter end, the yield differential between bonds maturing in 2 years and 15-year securities stood at 126 basis points. While we believe it is possible for the gap to narrow further, we are only 56 basis points away from the most compressed levels that we have seen since April 2000, and 189 basis points from the April 2003 levels. Given this weakening risk to reward skew, we are seeking to employ a barbell portfolio structure by increasing our holdings in the 2 to 3 year maturity range. This blend of front end exposure coupled with an investment in the 12 to 18 year segment should offer an enhanced total rate of return opportunity in this moderate growth, controlled inflation environment.

Asset Class Taxable-Equivalent Total Returns
July 1, 2000 - June 30, 2005 (5 Years)



* U.S. Treasury income returns are exempt form State income taxes and adjusted (3.25% in 2002 – 2003, 3.23% in 2001, and 3.18% prior) using a national state average (top bracket), net of Federal income tax.

** Based on an equally weighted national average Federal and State (top bracket) income tax rate (38.45% for 2003, 41.85% for 2002, 42.33% for 2001, and 42.78% prior – local taxes have not been considered in the analysis.