The Investor's Edge

C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Securities

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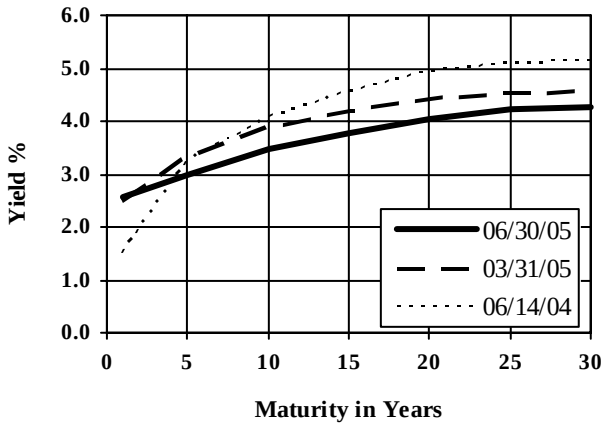
- **Background**

The Federal Reserve made two additional quarter point "measured" tightening moves during the second quarter that raised the targeted federal funds rate to 3¼%. Comments after the June 30 FOMC meeting indicated that Mr. Greenspan remains focused on raising the fed funds rate to a "neutral" level, implying that additional upward moves are in his play book. Other than being higher, it is uncertain what yield constitutes neutral. The futures market is currently forecasting a 3.85% level by year end.

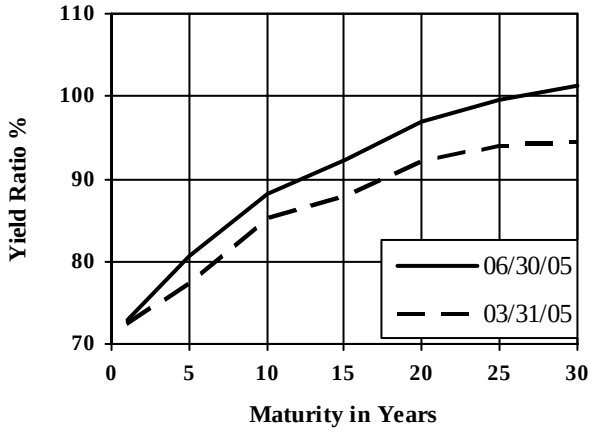
As shown in the accompanying graph, longer interest rates followed their own drummer and moved lower during the course of the quarter, generally in concert with the taxable bond market that was heartened by docile inflation reports, a significantly lower than expected gain in non-farm labor in May and strong foreign demand for U.S. securities.

AAA Municipal Yield Curves



The rally in the municipal sector trailed the Treasury market which caused the ratio of prime tax-exempt to Treasury yields to rise in most maturities and increase the relative attractiveness of the municipal market. As indicated in the second graph, at quarter end ten year prime municipals yielded 88% of the return on ten year Treasuries, up from 85% at the end of March. In the thirty year sector municipal rates moved slightly above Treasury yields. Strong demand for long duration taxable securities by defined benefit pension plans seeking asset/liability matches appears to be pushing long Treasury yields lower.

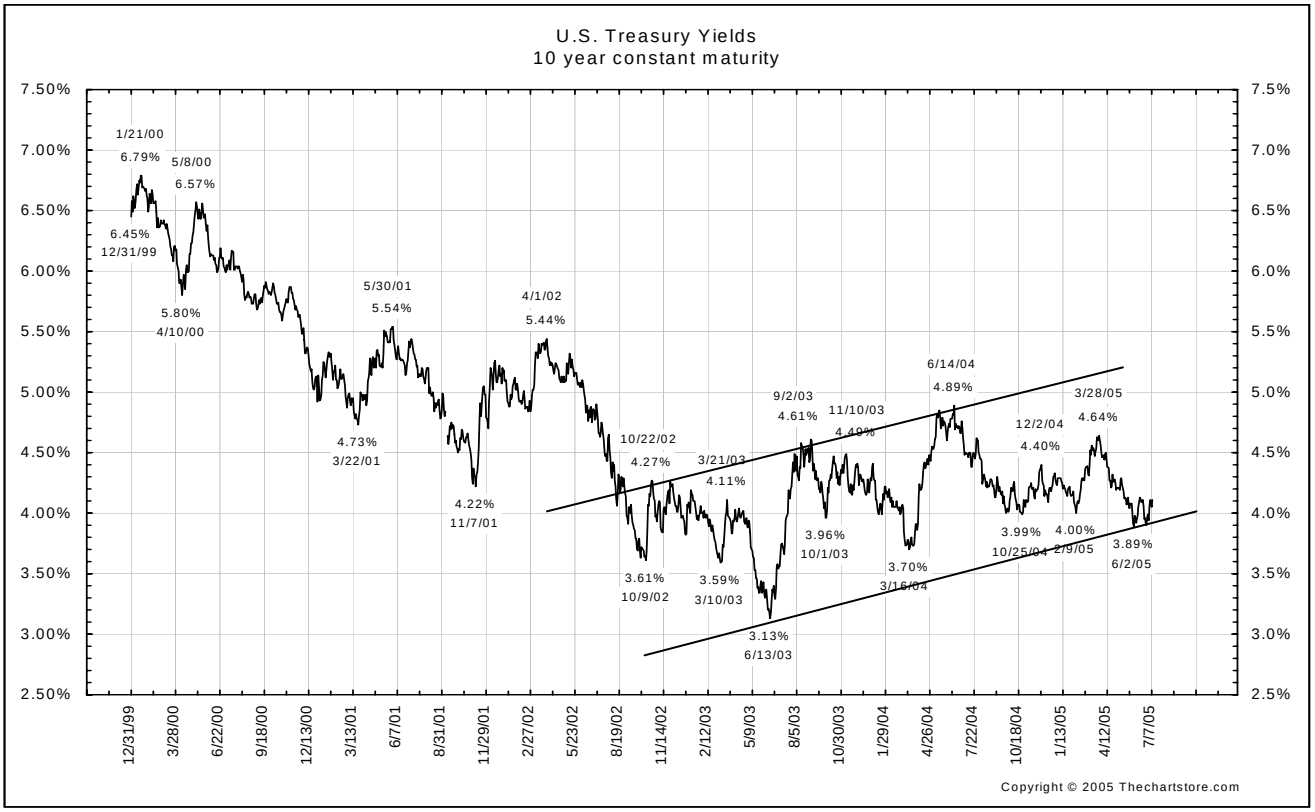
Prime Municipal to Treasury Yield Ratios



New issue supply set a record in the first half, spurred by heavy refunding activity. Volume totaled $207.6 billion, up 9.1% compared to the first six months of 2004. The previous first half record was set in 2003 when volume totaled $205.8 billion.

- **Outlook**

Can long rates continue to decline in the face of rising short rates? Previous interest rate cycles would suggest that this is unlikely, but long rates have not followed the conventional pattern over the year and may continue to move counter cyclically to short rates. As shown in the accompanying chart, courtesy of The Chart Store, ten year Treasury yields have declined erratically from mid-June of last year, about the time the Fed started tightening. Nine quarter point moves have notched the Federal Funds rate up from 1% to 3¼% while long rates have declined by about eighty basis points.



The economy is not showing signs of faltering and appears to remain on a real GDP growth path of about 3.5%, despite higher energy prices that the economy seems to be adjusting to with limited difficulty. This does not suggest an environment where demand slackens significantly, inflation moderates or the Fed deviates from their current agenda. Global competitiveness will keep inflation in check, but it is unlikely that price pressures will moderate.

Low interest rates provide investors with slender real returns and forces the question of what constitutes appropriate compensation for longer term investments? Ten year prime municipal bonds are currently yielding about 3.50%. A relatively small increase in inflation from current levels would turn a purchase today into a near zero, or possibly negative, real return investment. Expected returns are low throughout the investment spectrum creating a fragile environment. The U.S. now requires close to $3 billion of foreign investments each business day to offset the gaping trade deficit. There is nothing to suggest that these inflows will be disrupted in the near term given that Asian liquidity has to be invested somewhere and U.S. markets remain the deepest and most liquid in the world. Further, yields on Japanese and European bonds, potential alternative investments, are lower than in the U.S. However, the risk exists that a marginal shift in investment preferences away from Treasuries by foreign investors could have a dramatic impact on U.S. interest rates.

We are also influenced by the increased volatility risk associated with low prevailing nominal interest rates. To illustrate, a ten year par bond at current interest rate levels has a duration of 8.29 years (disregarding the de minimus impact). As interest rates rise, duration declines since a given rate change represents a smaller percentage move. For example, a hundred basis point move represents a 28.6% yield adjustment on a 3.5% bond but only a 14.3% change on a 7% bond. The following table illustrates the durations associated with ten year bonds at varying interest rate levels.

Ten Year Par Bonds

Coupon	Duration
2.0%	8.99 yrs.
3.5	8.29 (today's market)
5.0	7.65
6.5	6.99

Our primary goal in the management of clients' municipal bond portfolios is to not have negative total returns in any year. Increased duration (volatility) risk associated with the current low interest rate environment prompts us to maintain lower than normal portfolio durations. We are willing to give up some upside potential to protect against periodic upward volatility spikes that we expect will continue to characterize the near term investment environment. We are maintaining barbell portfolio constructions that are over weighted with short effective duration securities.

- **Return Considerations When Using High Coupon Bonds**

Our defensiveness and desire to avoid negatively convex securities has caused us to favor high coupon bonds in portfolio constructions. These securities moderate volatility risk and provide the potential for enhanced returns. However, investors must be cognizant of the yield to maturity associated with their portfolios and the related income flows and principal adjustments.

To illustrate, assume that a 5.50% bond with a five year maturity is purchased at a yield to maturity of 3.40% (reflective of the current market for premium bonds). The dollar price of this bond would be 109.58. The current yield is 5.02% (5.50/1.0958). Increased cash flow is being generated because of the high coupon, but the bond is "earning" the yield to maturity, or 3.40%. The following table illustrates the annual income flows and price changes associated with this bond at a constant 3.40% yield to maturity.

	Price	Price Change	(A) % Price Change	Coupon	(B) % Coupon Return	(A+B) Total Return
Initial	109.58					
1st Year	107.79	- 1.79	- 1.63	5.50%	5.03	3.40%
2nd Year	105.94	- 1.85	- 1.71	5.50	5.11	3.40
3rd Year	104.03	- 1.91	- 1.79	5.50	5.19	3.40
4th Year	102.05	- 1.98	- 1.89	5.50	5.29	3.40
5th Year	100.00	- 2.05	- 1.99	5.50	5.39	3.40

Next, assume that a $1 million portfolio is constructed that has the characteristics of the above bond. The initial million dollars could purchase bonds with an approximate $912,575 par value (ignoring accrued interest if bonds are not purchased on an income payment date). Over five years the portfolio will generate income of $250,958 (912,575 par X 5.50% X 5 years). If all of the income generated is spent, the principal value of the portfolio will decline to $912,575 at the end of the period. However, if income distributions are limited to the yield to maturity level (i.e. 3.40%), there will not be any principal erosion and the value of the portfolio will be maintained at the $1 million level at the end of the five years.

- **Risk of Municipal Debt Being Declared Taxable**

The Internal Revenue Service recently provided a warning that interest generated by municipal bond issues can be declared taxable if transactions don't comply with federal tax rules and issuance requirements. Non compliance with arbitrage rules or inappropriate private activity financings are the IRS's focus. Two Georgia Pacific Corporation backed issues totaling $54.8 million were declared taxable last month. Proceeds from these issues that sold in 1995 were used to construct a solid waste disposal facility in Oregon. The IRS action was prompted by the fact that the materials being processed in the facility did not meet guideline requirements. Our focus on general obligation and "essential service" revenue bonds seeks to avoid any such potential problems.