The Investor's Edge

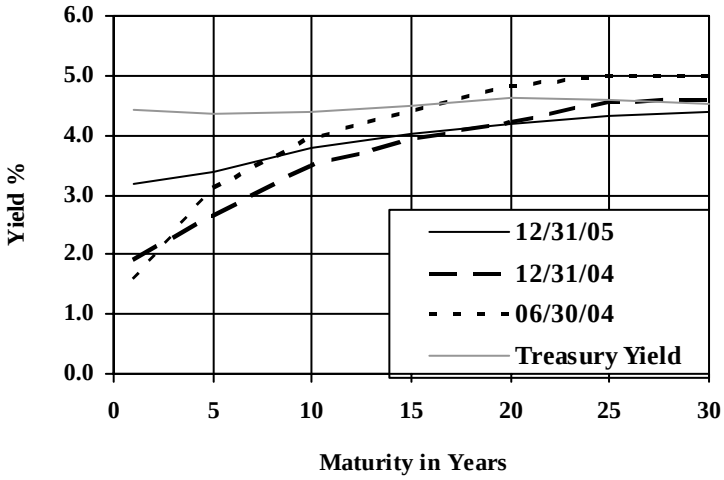
C.W. HENDERSON & ASSOCIATES, INC.

Investment Managers Specializing in Tax-Exempt Securities

December 2005

- **Background**

The fourth quarter held few surprises. Energy prices subsided somewhat from the post-hurricane highs while hiring bounced back. Housing activity showed signs of cresting in response to rising mortgage rates and the Federal Reserve tightened the monetary belt by two more notches as they moved the targeted Federal Funds Rate to 4.25%. Longer municipal rates moved higher in October and early November, but ended the quarter about where they started. Yields on shorter maturity bonds, that are influenced by Fed activity, continued to rise. The spread between one and thirty year tax-exempts closed the year at 120 basis points, down from 163 basis points at the end of September. The one to thirty year spread was 343 basis points in mid 2004 when the Fed started tightening. Interestingly, the Treasury curve remains significantly flatter than the municipal sector with only a 10 basis point spread between one and thirty year rates at year end. A steeper municipal curve is logical since investors demand increased compensation for credit and call risk as maturities are extended. Still, the dramatic difference in the taxable and tax-exempt curves is striking. The accompanying chart illustrates the tax-exempt yield curves that existed in mid 2004 and at the beginning and end of the past year. The 2005 year end Treasury curve is also included. Note the decline in long municipal rates since mid 2004 despite the Fed's thirteen quarter point tightening moves.



- **Outlook**

We anticipate that the Fed will tighten again at the January 30 FOMC meeting and bring the Fed Funds rate to 4.50% in their quest for monetary neutrality – the rate that contains inflationary pressures but allows sufficient latitude to sustain economic growth. Chairman Greenspan will then hand the monetary policy reins to Mr. Bernanke. The new chairman's philosophy and methodology will certainly vary somewhat from his predecessor's and it will take some time for the markets to develop confidence in Chairman Bernanke's leadership. It seems unlikely that the new chairman will make dramatic policy changes in the near term. The FOMC may make one or two additional moves in the coming months, but we expect that the end of this tightening cycle is near.

Investors will keep a watchful eye on Fed activity, but the economy will continue to drive market sentiment and bond yields. Those arguing that growth will slow in 2006 point to higher energy prices that will hinder consumer discretionary spending and a cooling of the housing market that could have a negative wealth effect and impede the public's ability to finance spending with home equity loans. The continued growth argument focuses on employment growth and the related income flow that is expected to provide consumers with sufficient means to weather the negative energy and housing effects. In addition, increased corporate capital spending should provide stimulus.

Our base case assumption is that real GDP will expand at a 3+% rate in 2006, spurred by continued, although somewhat moderated, consumer spending and reasonable corporate capital expenditures. Short rates will stabilize at near current levels as the Fed pauses to monitor the economic landscape. Inflation is expected to remain controlled due to intense global competition, but creep slightly higher as the energy prices are transmitted throughout the economy and wage levels increase. Longer rates are likely to remain range bound, but we would not be surprised to see them move somewhat higher in response to continued economic growth.

Importantly, we do not feel that the slight Treasury curve inversion is signaling an economic downturn. Typically long rates rise in response to Federal Reserve tightening and an inversion develops as short rates move up faster than long rates. The current situation is unique in that long rates have declined while short rates have risen. It appears that the decline in long rates has been prompted by two factors; belief that global competition, continued productivity and a proactive Fed will keep the inflation genie in the bottle and, probably more importantly, strong foreign demand for U.S. securities that counterbalances our widening trade deficit. Our bottom line is that we do not believe that interest rates are at levels that will stifle economic activity.

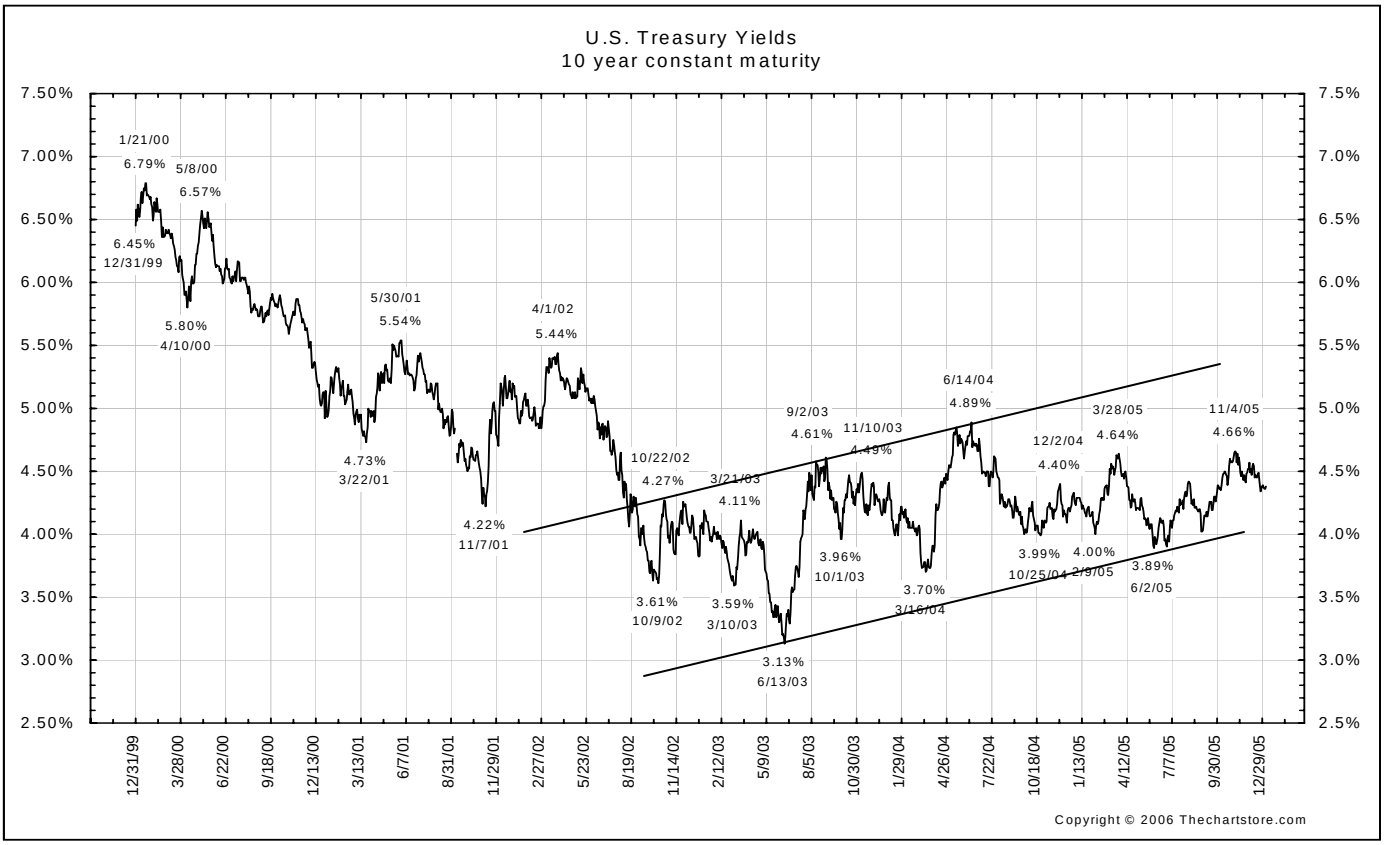
- **Current Strategy**

We extended portfolio durations during the past quarter from three years to about 3.75 years. Our action was in response to two factors. First, the increase in short rates has improved the risk/reward characteristics of shorter bonds. As we have pointed out in past newsletters, one of our risk measures is the yield increase that would produce a zero total return over a one year horizon for various maturity bonds. Of most importance in this analysis is the yield on five year prime municipals since our market neutral portfolio structures have average maturities that are slightly under five years. Shown below is the five year prime municipal yield that existed at year end and the yields that prevailed at the end of 2004 and in mid June 2003 when long rates bottomed. Also shown for each time period is the yield increase that would be required, over a one year horizon as each bond's maturity shortens from five to four years, to produce a zero total return (i.e. the bond's price decline offsets the annual income received). As is evident, a 103 basis point increase is now required to cause a zero total return as compared to 70 basis points a year ago and only 50 basis points in mid-2003. Our objective is to avoid total return losses in our clients' accounts in any year. As interest rates move higher, there is more coupon insulation to protect against total return losses. Our confidence level has increased with this figure at 100+ basis points.

Yield Increase That Creates a Zero Total Return Over One Year
Five Year Prime Municipal Bonds

Date	Coupon	Yield Increase
12-31-05	3.39%	103BP
12-31-04	2.65	71
6-15-03	1.90	50

The second factor that prompted our duration extension is that interest rates moved to attractive levels during the quarter. As noted in the attached chart, ten year Treasury yields moved to the 4.66% level in early November. At that time ten year prime municipal yields reached 4.0%. This appeared to be an intermediate high and, as a result, an attractive opportunity to commit cash to the market. This has subsequently proven to be the case as ten year municipal yields have since declined to the 3.80% level. We anticipate additional volatility in the coming year, but expect that the ten year Treasury yield will remain below 5%. If interest rates do rise to that extent, the ten year prime municipal yield would likely rise to the 4.30% level, about 86% of the ten year Treasury rate.



We typically purchase eighteen to twenty year bonds with ten year call protection when making commitments to the long end of our clients' barbell constructed portfolios. This is generally the area where the curve flattens and little incremental yield can be garnered with maturity extensions. The flatness of the current curve has prompted us to focus on the ten to fifteen year sector as we have lengthened portfolio durations. The yield pickup provided by extending from fifteen to twenty years is currently only eighteen basis points. We anticipate that there will be opportunities to extend these recent purchases to the twenty year area with significantly greater yield pickups than are currently available.

- **Impact of Premium Bonds**

  Several of the strategies that we employ in constructing portfolios utilize high coupon bonds. High coupon bonds with short effective maturities provide opportunities for enhanced returns with limited volatility risk, while high coupon longer bonds limit negative convexity and de minimus risks. In both instances high coupon, premium bonds provide the opportunity for enhanced returns with controlled risk.

  It is important however that clients understand that the use of high coupon bonds provides high levels of current income but, some of the income represents a return of principal and compensates for the above par prices paid for the securities. To illustrate, assume that a 5.50% ten year bond is purchased at a yield to maturity of 4.0%. The dollar price of the bond would be 112.263. The current yield on this bond is 4.90% (5.50/112.263 X 100). As the maturity of the bond declines from ten to nine years its price (assuming a constant 4.0% yield to maturity) declines to 111.244, or by 0.90%. Therefore, during this one year holding period, the bond's total return consists of the current return and the percent decline in the price of the bond due to maturity shortening.

  The return on any bond not priced at par is comprised of both components, the current return and price change due to maturity shortening. The two are additive and equate to the yield to maturity. Current yield represents cash flow. Yield to maturity reflects what the investor is actually earning!

- **Firm News**

  C.W. Henderson & Associates had an excellent year in 2005 with solid growth in assets under management and good performance relative to our primary benchmark. We thank all of our clients, associates and friends for their confidence and support during the past year and wish each of you health and prosperity in 2006.

Craig W. Henderson Thomas L. Mallman Jeanhee Hoffman