Caprin Asset Management, L.L.C.

Caprin Asset Management's disciplined investment process is dedicated to helping investors navigate the complexities of the fixed income markets by preserving and enhancing investor wealth through thoughtfully constructed, professionally managed portfolios.

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January 2006 Newsletter

2005 was a year of many events that had the potential to impact our economy. Most notably, three major land falling hurricanes devastated the Gulf Coast and disrupted the flow and price of natural gas and energy products, sending prices consumers pay skyrocketing. Overall economic activity remained strong although US airlines faced increased cost pressures and the US auto industry continued to deal with revenue and pension hardship. More people were employed last year and productivity remained strong.

Consumer spending seems adequate, reflecting a degree of consumer confidence, and Government spending continues to grow, with terrorism to fight and infrastructure improvements to make. Thinking back to the post hurricane time, the 'resiliency of the US economy' was discussed frequently, and this strength continues for the time being. Foreign purchases of US securities blossomed, keeping longer term fixed interest rates low which supports the affordability of housing. Considering these economic factors, many expect the Fed to continue raising rates for at least one or a few more meetings, bringing the Fed Funds Rate closer to 5.00% at the end of the second quarter 2006, and giving the new Fed chairman a seamless transition from a monetary policy standpoint.

The announcement of Dr. Ben Bernanke as Chairman Greenspan's replacement at the helm of the Federal Reserve was one of the prominent market moving events of the year. Under a new regime, the markets are likely to be more volatile as investors determine the amount of transparency available from the FOMC and consider how a new monetary policy stand may impact the US economy. After thirteen consecutive, 'measured pace' rate hikes, the shape of the yield curve has moved into new territory, inverting at year end. The last two recessions were preceded by inversions, but many believe this time will be different.

Looking forward

The US economy is by and large driven by consumer spending and any change in Fed policy may be driven by concern over a slow down or declining business investment. Interestingly, the US consumer has become quite adept at finding sources of money to support spending habits and a fairly high standard of living compared to the rest of the world. The phenomenon of 'wealth effect' spending became quite evident in the stock market bubble of the late 1990s and has been perpetuated this decade by mortgage refinancing and other means of creative financing. Can the consumer, with a microscopically low savings rate, continue to balance their sources and uses of funds? While income levels are improving, are the costs of health care and energy taking their toll? Will higher payments on resetting variable rate mortgages take a bite out of cash flow? These are a few causal

influences we ponder when thinking about consumer's willingness to believe the Fed statements that inflation is under control and that the time is approaching to call a 'time out' to assess the effect of its eighteen month measured rate increase policy. In short, while there are concerns, we see the economy continuing to grow in 2006 albeit at a slower pace. We believe the Fed is nearing the end of its rate increases and looking for a period of rate stability as the economy adjusts to a new equilibrium.

Strategy: Short term Accounts

As money managers, we strive to execute an investment strategy for our accounts which recognizes the approach of turning points. As the market anticipates a change, weekly fluctuations in interest rates become exaggerated as investors digest and react to news in search of the level of interest rates appropriate for the future. We evaluate the pros and cons of these developing market trends, test our strategies, and pursue investment opportunities consistent with the strategic goals we and our clients have set for their portfolios. At present, we continue to invest our portfolios with relatively short maturities to provide liquidity and take advantage of the Fed's push to higher rates. As we monitor the fixed income markets, we are looking for investment opportunities to lock-in more income for each portfolio. The pace of transitioning to longer maturity investments will quicken the nearer we get to a pause in the Federal Reserve's measured pace of interest rate increases.

Strategy: Total Return Intermediate Accounts

In March 2005 the yield curve presented an opportunity to get 'neutral' in duration to our conservative, intermediate term benchmark. We have learned that foreign influences have had a real and significant impact on the shape of the yield curve and that longer maturity securities can stay low even while the Fed is increasing short term rates. The ten year Treasury has been held in a trading range since June 2004 that is just under 1%, ranging between 3.90% and 4.85%. If you recall, it was June 30, 2004, when the Fed began its rate hikes. Historically, longer maturity securities lose value when the Fed undertakes a series of rate hikes. During those periods, managers who are more conservative tend to out perform.

Responding to this historically 'different' period, many investment managers learned we had been too conservative. In March as the ten year Treasury approached the high end of its trading range, 4.64%, Caprin reevaluated its strategy and began to pursue a 'neutral' duration target. This involved buying longer maturity securities, typically ten year bonds or those a little longer yet priced to a ten year call. Coupled with this neutral duration strategy, we positioned for a 'flattening' yield curve where shorter maturity securities rise in yield more than longer ones. Performance was enhanced due to these changes although absolute returns were low across this 'intermediate' style.

As we start 2006, we will continue to evaluate our duration target strategy and expect to make adjustments as the year progresses and macroeconomic changes unfurl. Should the Fed stop raising short term rates soon, we may unwind our 'flattening' bias by increasing purchases in the 2 to 5 year maturity range rather than short and longer maturity emphasis.

Equity Market views

For 2005, a review of the major domestic indices shows generally flat performance last year, ranging from a slight decline in the Dow to a 3% gain in the S&P 500 ex-dividends. In many ways, the process of sorting out the course of the economy in the face of natural disasters, a war, budget deficits, and higher interest rates has kept the equity indices in check for the year. The new year started off with a positive tone largely on the premise that the Fed may soon let interest rates stabilize and thus possibly giving the equity markets some breathing room.

As we write to you now, the stock market has begun what appears to be the beginning of a long overdue correction. The excuses for such a down move are many including oil supply and price concerns due to the frightening rhetoric emanating from Iran and the headwinds of higher interest rates, unprecedented current account imbalances and a host of other issues we mentioned earlier. Price to earnings ratios have started to contract as they left no room for disappointment at what has been a historically high level for this ratio. Recognizing that corrections are an inherent part of stock market performance, let's look at some important positive influences in 2006 on equity prices:

1. Higher household and corporate incomes coupled with record levels of net worth and highly supportive financial conditions.
2. Steady if not spectacular consumer spending.
3. High corporate productivity and a renewal in business spending reflecting corporate America's need to reinvest for growth.
4. Government spending to repair hurricane damage should continue to stimulate the economy.

All in all, business performance is still impressive with corporate profits in a fifth year of growth. Most importantly inflation is mild, wages as a percentage of GDP are approaching record lows and industry's margins are at record levels. We anticipate volatility in the market to increase as investor's will pay for the elevated risk/reward tradeoff of the equity market.