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.

William W. Flowers
President

Cheryl L. Page, CFA
Managing Partner

Edwin B. Horner, III
Managing Partner

Mark B. Sisisky
Managing Partner

Suzanne S. Harris
Senior Vice President

Michael L. Hoover, CFA
Senior Vice President

R. Preston Nuttall, CFA
Director of Cash Management

Adam S. Plotkin
Assistant Vice President

Ashley L. Engel
Assistant Portfolio Manager

Peyton M. Studebaker
Portfolio & Operations Specialist

Richmond
Tel. (804) 648-3333
Fax (804) 648-6651
7100 Forest Avenue • Suite 303
Richmond, VA 23226
caprin@caprinbonds.com

Lynchburg
Tel. (434) 386-6491
Fax (434) 386-6490
PO Box 684
Lynchburg, VA 24505
ehorner@caprinbonds.com

Ocean Isle
Tel. (910) 579-0533
Fax (910) 579-0593
6597 Spencer Place
Ocean Isle Beach, NC 28469
sharris@caprinbonds.com

July 2004

A Look Back

Much to no one's surprise, the Federal Reserve increased the Fed Funds rate by 25 basis points at their June 30 meeting. Additionally, they indicated their intention to remain vigilant in their fight against inflation by standing ready to increase rates at a "measured pace." The first fed tightening since May of 2000, and the first move since the June 03 easing, is considered by most to be the first of many, although the number, sizes and duration of fed tightening is still being discussed by everyone except the Fed itself.

2Q 2004 was a rocky one for fixed income. Yields rose and prices fell across the spectrum. According to Lehman Brothers, Municipals fared better than the broader Aggregate index, and the General Obligation (GO) index fared slightly better than the main Municipal index. Within the municipal spectrum this seems to indicate that a greater desire exists for higher quality, more liquid paper such as GO's. For the quarter taxable Returns ranged from -1.13% (1-3 year US Government Bonds) to -5.73% (20+ US Treasury Bonds), while municipal returns ranged from -.30% (1 yr GO's) to -3.61% (22+ year municipals). April and May were decidedly negative, but we saw a rally in the latter half of June in front of and after the Fed decision.

Some of the headlines that influenced the broader markets over the last quarter focused on economic data, the Presidential election, and Iraq. In the municipal world there is an increasing focus on pricing transparency in the secondary market. Specifically, increasing employment and the specter of rising inflation have commanded the most attention of economic analysts. We have been inundated with hypotheses about the next Presidential Election- Bush v. Kerry, something that the pundits will be discussing ad-nauseum until November. Then there was the early handover of Iraq to their Provisional Government; many thought this was an attempt by our government to grandstand, but by and large there is agreement that it is better to have Iraqis leading Iraqis. Regarding transparency in the municipal marketplace, the NASD fined eight securities firms and ordered them to pay restitution to their clients due to excessive mark-ups.

A Look Ahead

The Fed Funds Futures have priced in increases at each of the next four meetings of the Open Market Committee. At this writing the August contract is 1.43 and December is 2.11, which means that the market expects the Fed Funds rate to at least be 2.0 by year end, and it is pretty evenly split between expectations of 2.25 as well. The market has completely written off any historical hesitance to raise rates in front of an election that the Fed might have had. Continued Fed action will certainly bring short term rates higher, and it is possible that we will see the curve flatten as a result.

In addition to the increasing Fed Funds rate, other events to consider in the coming quarter and remainder of the year could be an overseas credit crunch, problems in the rapidly expanding Hedge Fund industry, rising inflation, and potential terrorist activity surrounding the Olympics or Election. We certainly do not want to sound alarmist, but we do think it is important to point out some of the things that could have an impact domestically and globally. After all, the markets move as much on perception as they do on fact.

We recently have seen some discussion about a prominent Russian bank having liquidity problems prompting the Russian government to consider nationalizing that bank. At the same time there has been a below the radar shake-up in the Russian military; neither event instills much confidence. Additionally, as hedge funds have become almost as pervasive as mutual funds, we think it is important to highlight the potential for trouble as the popularity of hedge funds continues to grow. Few people can think of more desirable terror targets than the upcoming Olympic Games or our Presidential election. Although any successful attack is highly unlikely, despite everyone's best efforts the chance for success remains; should anything like that happen, there will likely be a flight to high quality investments yet again.

Municipals

The yield curve is still very steep in the short end, with a 230 basis point spread between 1 and 10 years. In contrast, the spread between 10 and 30 years is only 100 bps. Because of the shape of the yield curve and the promise of additional Fed action, we are still maintaining a defensive posture, and we are shortening our duration target to approximately 3.5 years. As capital preservation is our primary focus, we are hesitant to lengthen portfolios in front of Fed action, preferring instead to structure portfolios in such a way as to take advantage of the yield curve's steepness and create opportunities to reinvest at higher yields as rates rise. One could describe the shape of portfolios as a "modified barbell," with concentrations at each end as well as exposure in the middle; the exposure at the 10 year range exists because of the pick up in yield, and that is insulated by heavier weightings in the short end, which rolls off at par to be reinvested at then current, and hopefully higher, rates. In the short end, we expect to begin using variable rate bonds (VRB's) as a cash alternative; VRB's price at par only, but their coupon rate responds to changes in interest rates faster than money market funds.

Cash Management

To begin its defense against inflation, yet not choke off the fledgling recovery, the Fed has initiated a measured approach to increasing short term rates- the term "measured" has almost universally been defined as 25 basis point moves. This measured approach likely will continue through year end and beyond. In the weeks leading up to the Fed's June meeting, the market had more than discounted the first of these increases, rising by more than ¼ point. Taking advantage of higher rates, we lowered our average cash position from 20% to 15%, and, depending upon specific account guidelines, we targeted the 10 to 18 month range. At this point we will again allow cash to build somewhat in anticipation of more market weakness in front of the next Fed meeting. As such periods of weakness occur, we will again enter the market and reduce cash positions.

Equities

After a slight lull in June, the economy appears poised to resume its cyclical advance. Stocks are currently testing their May lows, and bonds are rallying in the face of everyone expecting yields to rise. The bottom line- equity markets are, for the most part, directionless, and volatility is low. Confidence about the near term direction of stock prices ahead of political conventions and heightened terror alerts appears to have raised the equity risk premium. Remember, the markets hate uncertainty. All of this begs the question, "What should clients/investors do with their money?" Our suggestion remains the same: have a plan and follow it. Equity exposure should be commensurate with your risk tolerance. The next several months could prove to be a bumpy ride.

Food for Thought: Risk v. Reward

The prospects for a rising interest rate environment have brought into question the investment strategy for many fixed income investors. The thought of moving into money markets with paltry returns to preserve capital is offset by the lure of the higher interest rates of longer maturities. Perhaps a more appropriate analysis would be a risk/reward analysis versus an income return analysis.

A portfolio built with very short maturities expects that rates are going up without a doubt, and the investor is willing to give up some income to preserve principal. The risk is that rates do not rise fast enough to offset current returns. But the long term investor has a slightly different view. He may believe rates are rising, but he has built a portfolio of laddered securities structured to mature as rates rise. The strategy here is two-fold: first that the rise in rates is gradual, insulating the portfolio from a rate spike; second, that the timing of maturities coincides with peaks in the interest rate cycle. While both scenarios have merit, both make forecasts that rely upon impeccable timing and calm markets.

Both investors believe that they are right, but perhaps they would be best suited by meeting somewhere in the middle. A portfolio with an average duration of 3.5 years has an income characteristic greater than 3 times that of money markets. Conversely, a portfolio with an average duration of 3.5 years has a volatility characteristic that is approximately 60% lower than that of a 15 year laddered portfolio, which typically has duration of 6.5 years. And, at the same time, the 3.5 year duration portfolio captures about 75% of the yield. A spike up in interest rates could have a devastating effect on the price of the 15 year laddered portfolio.

The Fed's posture, that of raising rates at a "measured pace," should warrant caution and vigilance. Much to everyone's surprise, the fixed income markets responded positively to the Fed's action and current economic news by rallying in price resulting in a decline in yield. Clearly, the prediction of the future direction of interest rates is a challenge for even the best economists. In the fixed income markets, big tactical bets are risky and unnecessary. In today's market environment, a balanced, well constructed portfolio will yield the best total return while preserving capital and generating income.