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Supreme Court Hearing Muni Bond Taxation Appeal

Earlier this year the Kentucky State Supreme Court ruled that the Commonwealth of Kentucky could not apply different taxation rules at the state level to municipal bond interest paid by Kentucky domiciled issuers (not taxed) versus interest paid by non-Kentucky domiciled issuers (interest is taxed). Because State of Ohio courts had decided there could be differing tax treatment for state income taxes, the U.S. Supreme Court agreed last month to hear an appeal from the Commonwealth of Kentucky seeking to overturn the ruling of its highest court.

The U.S. Supreme Court appeal has generated a great deal of speculation, but a ruling is not expected until the spring of 2008. A recent Supreme Court decision allowed states to impose differential pricing on inter-state and intra-state commerce, arguably setting a precedent for differential taxation of in-state and out-of-state municipal bond interest. On the other hand, there is justification for eliminating the differential since not all states apply a uniform practice. If the U.S. Supreme Court upholds the case, approximately 40 states will need to choose a consistent tax treatment of municipal bond interest for state taxes, either all bonds regardless of domicile are taxed or they are all tax-free. Due to the uncertainty surrounding the Court's ruling, which is more than a year away, we do not think that wholesale changes to portfolios are appropriate at this time. Please note this case *does not* impact the Federal income tax exemption for municipal bond interest.

Caprin provides state-specific municipal bond management for clients who benefit from preferential state taxation *and* national accounts with no preferential benefit. Caprin's all-inclusive experience positions clients to benefit from professional management under either outcome in this appeal. We will keep you apprised as additional information surfaces.

Highlights:

- Kentucky case could impact muni market in 2008
- Low interest rates fueling large boom in bond issuance
- Fed Funds rate pause seems likely to Continue
- Caprin maintaining flexible posture for client portfolios

"The emphasis on controlling inflation has become paramount as bond yields have risen."

Bond Issuance at a Record High

2007 thus far is on pace to set a new record for the largest total amount of municipal bonds issued in any given calendar year. Historically low interest

rates and widespread infrastructure upgrades and expansion are fueling the boom in bond issuance.

The record number of issues for the first part of the year has led to greater bond availability, providing opportunities to purchase bonds with attractive yields for reasonable prices. Last fall, we saw bond issuance dwindle in the face of gubernatorial elections. With the new legislatures settled into their posts, new hospital, school, and road development projects are getting underway in response to voter mandates. The shifting of the supply-demand balance has helped improve the relative attractiveness of municipal bonds, overcoming the 'tight' market conditions we witnessed during the last half of 2006.

Caprin Strategy

The Federal Reserve's May 9th meeting produced little change in the Board's outlook for the economy or monetary policy. The bellwether Fed Funds Rate was held at 5.25% for the seventh consecutive meeting, as Fed Chairman Ben Bernanke acknowledged a slowing in the U.S. economy but reiterated that controlling inflation would remain a priority. A month later, though, the emphasis on controlling inflation has become paramount as bond yields have risen. In response to rising yields, Merrill Lynch, Goldman, UBS, and PIMCO have radically changed their forecasts. Each firm now expects the Fed to remain on hold throughout 2007 rather than reduce its target rate multiple times.

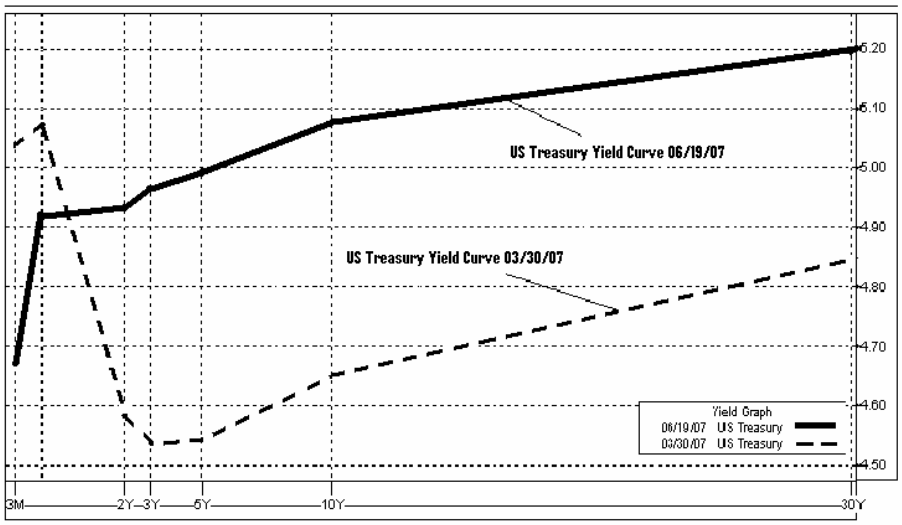

Figure 1. US Treasury Yield Curves—End of 1st Quarter 2007 vs. Today (06/19/07)

Caprin's Investment Committee agrees that the Fed will remain on hold this year and continues to maintain a conservative posture in the face of economic uncertainty. Our duration target of 4.25 years and our preferred portfolio structure continues to provide client accounts with flexibility as the current environment evolves. Should interest rates actually decline, current holdings in our managed bond portfolios should appreciate in value as a result. If rates rise, portfolios are carefully postured to minimize extreme swings in value. In preparation for either scenario, Caprin has defensively positioned its portfolios to protect against potential surprises in an uncertain market environment.

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