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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October 2004

News

We are excited to announce that R. Preston Nuttall, CFA, and Michael L. Hoover, CFA, joined Caprin in May of this year and expand our taxable fixed income investment services. Both Preston and Mike have spent their investment careers in the Mid-Atlantic region and bring with them extensive experience gathered over the past 40 and 19 years, respectively. In the late 1970's Preston saw that municipal, corporate and not-for-profit short term fixed income portfolios could earn better returns when invested outside of a money market fund. This began a money management career which served these constituencies during Preston's tenure at Capitoline Investment Services, Wheat First Securities, and Parata Capital Management. Mike and Preston's paths first crossed at Capitoline, where Mike began his investment career as a portfolio manager for income-oriented retirement plan assets. In 1988 Mike joined T. Rowe Price Associates for the next 13+ years as the senior investment officer for the firm's stable value division, which managed fixed income portfolios for corporate and governmental retirement plans. Interestingly, both Preston and Mike were asked to relocate their families during the financial services consolidation of the last 5 years, and both elected to retain their regional roots. Mike and Preston chose to join forces at Parata Capital Management to continue a successful strategy of assisting municipalities invest their short term fixed income portfolios.

After a brief transition that resulted in the transfer of 100% of Preston and Mike's client base, Caprin is now better positioned to offer focused taxable portfolio management for our clients. Our goal in broadening our services is to ensure we are positioned to meet the fixed income needs of our clients, regardless of tax status, and that we will do so by extending the conservative, capital preservation management style that is the hallmark of our practice. We welcome the opportunity to discuss our capabilities with you.

A Look Back

As we discussed in our last newsletter, the Federal Reserve Open Market Committee (FOMC) had just begun its plan of raising its Fed Funds target at a "measured pace." Since then, the FOMC has raised its target twice more, bringing it to 1.75%. The Olympics went off without a hitch, the fight against terror continued, and Afghanistan held its first democratic elections. With any luck, the same will happen in Iraq. Discussion died down in Russia about centralizing one of their major banks, although there have been recent indications that they may begin selling off assets of Yukos, one of their largest oil companies, to pay its past due tax bill. China and Japan continued to own vast amounts of US Treasury Debt and have not indicated any change to that policy.

One might have thought that the distinct change in tone from accommodative to that of a steadily increasing Fed Funds Target Rate would have caused the bond markets to sell off. Rather, non-short term bonds had one of the strongest quarters of the last few years, in most cases bringing returns for the year back into positive territory. According to Merrill Lynch, their Intermediate Municipal Index returned an impressive 3.5% for the quarter, the 5 year treasury returned about 2.98%, and the Lehman 5 Year GO Index returned 2.78%.

Quite a few things may have contributed to the impressive rally. An increasing number of economists lowered their opinions about the strength of the economy, oil prices surged to over 50 dollars per barrel, the deficit kept growing rapidly, and the Presidential Debates have brought the race to a virtual tie. There was even talk about needing to once again raise the Federal Debt Limit from its current level of 7.3 trillion dollars. In general, uncertainty is never a good thing for the economy, frequently bad for the equity markets and causing a flight to the quality of the bond market.

A Look Ahead

The first and most obvious factor to consider in the coming quarter is the Presidential Election. Second is the elevated price of oil and other commodities. Third is the fact that the US has yet again run into its statutory debt limit, forcing Congress to either raise the limit or simply stop spending. Last is an interesting idea about inflation from a macro perspective discussed by Paul McCulley, Managing Director of PIMCO Funds.

Although the election is only days away, the markets quickly react to any change in the polls. We have seen this kind of reaction most notably in the equity markets. After the debates finished, Bush and Kerry had drawn to a statistical tie. Uncertainty causes markets to meander, overreacting to any change in tone or tide. And depending upon the outcome of the Presidential Election, the markets might behave differently.

Rising oil prices and the resultant higher gasoline prices tend to hit the consumer directly by reducing available cash for other purchases. In many parts of the country we will probably be seeing higher heating oil and natural gas prices as well; pundits have said we could expect prices 60% higher than last year. Couple this rise in energy prices with higher than normal prices for other commodities like beef, pork, milk or orange juice, courtesy of hurricanes Ivan, Jeanne, Gaston and Charlie, and you could see a reduction in consumer spending that could make its way into the bigger economic picture in the form of a slowdown.

Normally, paying attention to the debt limit wouldn't be a big deal, but when Congress bumps up against the 7.3 Trillion dollar limit for the third time in less than four years, we think that could be important. Granted, Congress has simply raised the limit each time and will likely do this again when they reconvene after the election. More debt usually means higher yields because there is less demand to gobble up new bonds. However, if China and Japan continue to purchase US Treasuries with the proceeds from the sale of their own bonds, then we could continue to see yields low for some time. We need to remember also that China is a growing part of our trade deficit. So as long as we keep purchasing their goods, China is still encouraged to buy our bonds.

Every so often one finds an article or idea to be truly interesting and from a unique or informative perspective. Paul McCulley raised an interesting idea in an address he made to the CFA Institute. McCulley basically said that our economy cycles between being driven by capitalist influences (i.e. the markets) and by democratic influences (i.e. the government), and these cycles can last for 20 or so years. Depending upon which "forces" are in control, inflation behaves very differently. McCulley deems managing inflation expectations to be an asset manager's most important job.

Capitalism, according to McCulley, is inherently disinflationary, while Democracy is inflationary. The capitalist bull market of the 80's and 90's ended abruptly. What we saw during that bull market was an impressive display of capitalism at its best. Discretionary income rose, asset levels rose, and buying power increased; the markets became more efficient, and the consumer benefited with an increased standard of living. Several factors may have influenced the cooling of the capitalist driven economy:

September 11, a change in monetary policy to chill the "irrational exuberance," an increase in corporate governance resulting from the Sarbanes-Oxley legislation, and a huge budget deficit. It does seem that the driving force behind the economy at this point is democratic, in the form of significantly increased government spending. As the need for spending continues while tax revenue declines, we would expect to see our debt level rise. More debt generally means higher interest rates, and, if history can be any guide, a government driven economy inevitably leads to higher inflation. Higher inflation leads to higher interest rates.

Municipals
Given the increasing number of varying opinions about the health of our economy, interest rate forecasts, political events, and the likelihood in the near future for the Fed to raise its Fed Funds target, we will continue to maintain a slightly defensive duration target. We believe it is always better to err on the side of safety by preserving capital first and then generating an acceptable amount of income. Additionally, we will continue to make measured adjustments to our clients' portfolio duration in keeping with the duration targets set by our Investment Committee. To this end we will be executing transactions to capture unrealized gains and losses in an effort to both be tax efficient and to harvest the value that those gains and losses represent. The cash created by these transactions will then be used for purchases to fine-tune each portfolio's yield curve structure, income potential and duration.

Cash Management
Prior to the Fed's June meeting, when the first 25 basis point increase in Fed Funds was initiated, the spread between Fed Funds and the two-year Treasury was a whopping 180 basis points on the expectation that the Fed would be tightening for an extended period. Because of the relative attractiveness of bonds with 12 to 18 month maturities at that time, we invested a meaningful portion of our short term positions to enhance portfolio yields. Since June, the Fed has raised the Fed Funds rate an additional 50 basis points, bringing it to 1.75%. However, due to a lagging economic recovery and the fear of an oil induced stall, yields on bonds with maturities 12 months and greater are actually lower now than in June, so the relative attractiveness seen then has waned. Because we are not being compensated for buying longer maturities, especially in light of additional Fed increases, we have allowed our short term position to again move to the 20% level we had in May. In managing our short term accounts, we are continually striving to maintain an attractive current yield while retaining the flexibility to capture opportunity in a rising rate environment. For these reasons, our short term positions will not exceed our current target, and when there is value in buying longer maturities we will aggressively work funds into the market to capture those yields.

Equities
The dilemma is this: equities are an asset class whose value depends upon long term assumptions regarding future cash flows from a corporation's operating performance. The cash flow can then be discounted depending upon current interest rates, which, in theory, can make it difficult to determine appropriate price-to-earnings ratios and stock prices. Bonds provide a *certainty* of return while stocks provide a purchase option, if you will, on the future earnings of a company. Further mitigating the uncertainties of equity investing is investor psychology. Optimism reflects itself in higher prices and pessimism in lower prices. We could write a dissertation about equity investing, but space, and probably your patience, would not permit it. Allow us to say, however, that one should only own the highest quality securities, be prepared for periodic drawdowns of your capital, and have a long term investment horizon.

As always, thank you for your continued trust in Caprin. We strive to do something good for every client every day.

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