



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 2005: The Beat Goes On

Once again in the third quarter, the Federal Reserve Board raised rates by 25 basis points at each of its meetings, pushing its key Fed Funds Rate to 3.75%. That makes eleven meetings since June 2004, and with economic growth at a satisfactory level, eleven times the same action has been taken. But while the Fed's stated policy of raising rates "at a measured pace" is proving well-titled, recent events have introduced factors that may test policymakers' resolve.

As the second quarter ended, rising energy costs, excesses in the housing market, and a savings rate hovering near zero all pointed to consumers spending beyond their means. Then the third quarter delivered a double-punch "perfect storm" in the form of Hurricanes Katrina and Rita, sending energy costs through the roof and putting pressure on our leveraged economy, which doesn't have much room for error. There are indications that consumers cut back on spending in the face of high gasoline and other costs, and that the housing market slowed as interest rates rose and consumers paused. There are also signs that businesses are passing along overdue price increases, and the toughest test yet for consumers may be substantially higher winter heating costs.

All of this brings the Federal Reserve face to face with a "conundrum" of its own. Should it continue its "measured pace" toward higher rates, or should it stop and see how the economy responds? Recent rhetoric from the Fed governors points toward a continuation of policy as the third quarter disruptions are viewed as "short term." Furthermore, the Fed has hinted concern about supporting a standard of living based upon home equity, leverage, and exaggerated appreciation expectations.

Municipal Portfolios

Over one year ago we started using the S&P Investortools Trust Index as our total return benchmark. This decision stemmed from our desire to orient clients who are accustomed to thinking in terms of a 10 year laddered portfolio where one simply purchases ten-year bonds upon maturities to a benchmark that is consistent with that ladder. The S&P Investortools Trust Index is a laddered portfolio that is shorter in duration and therefore generally has less volatility than the Lehman 5 yr GO Index we had used in the past.

Five out of the last 12 months had negative total returns, and our composite generally performs better than our benchmark during those months. Therefore, on a gross basis, we outperformed our benchmark over the last year. We continue to hit singles and doubles to generate net outperformance, and we are currently taking advantage of credit choices and callable structures for that added value. The "barbell" emphasis we have employed is less appropriate in the current environment even though the municipal market is still relatively steep compared to the Treasury market. Therefore, portfolios may transition to a more laddered structure now than they were earlier in the year.

One strategy we implemented in many portfolios during September was the swap of 3 year municipal bonds with yields around 3% into the ten-year area yielding approximately 3.85%. The timing of this swap was particularly important because, during the weeks we were looking for the "right" structure to buy, Treasury yields rose from 3.82 and 4.09 in three and ten years to approximately 4.21 and 4.35 respectively. A significant amount of after tax value was gained from this type of extension swap.

Taxable Portfolios

We believe that the Federal Reserve will remain on its present course for the next few months and will settle on a “neutral” Fed Funds Rate in the 4.0% – 4.5% range. At that point, the Fed is likely to adopt a wait-and-see position in early 2006 so the Board can properly gauge the course of the economy.

As rates rose over the past several quarters, we invested short term so that the yields of our portfolios moved higher along with market rates. Market conditions and expectations during the third quarter presented opportunities for executing our policy of methodically transitioning a portion of these short term positions. We anticipate continuing to selectively invest in longer maturities to lock up higher rates as the Fed approaches what is likely to be a leveling off of their interest rate hikes.

Equities

As an equity investor today, one can hardly be faulted for being a bit nervous. The headlines practically shout at us about devastating hurricanes, hawkish fed governor statements with accompanying interest rate increases at every meeting, two fronts on the war against terrorism, and oil prices extrapolated by many experts to be at \$100 per barrel within the near future. All of the above negatives, and many more, are true. However, facing down risks is nothing new. Mathematically speaking, crises often have only a limited impact on the market for the following reason: at about 20 times earnings, next year's earnings constitute only about 5% of a stock's extrapolated value. The remaining 95% depends upon profits delivered over remaining years. If this is the case, a temporary 20% drop in earnings in any one year should move the stock (erratically to be sure) by only 1% as investors bid prices back up in the following years as long as we believe earnings will bounce back from these extraneous negatives. Prices recover over time as the initial shocks wear off. The only thing to fear, it would seem, is the permanent impairment of earnings. That is why we have always urged our clients to hold high quality equities managed by very able managers and financial advisors.

Why Active Bond Management Adds Value

Often Caprin's professionals are asked to make presentations to groups and individuals interested in active bond portfolio management. These groups and individuals may have existing passive (i.e., laddered) portfolios, or they may be new to fixed income investing in general. With this in mind, we thought it appropriate to include some comments from the article “Active Versus Laddered Municipal Bond Portfolio Management” published in the Summer 2003 issue of The Journal of Wealth Management. When the article was written, authors Rosa Welton and Douglas S. Rogers were with Deloitte & Touche Investment Advisors. Ms. Welton was an investment analyst and Mr. Rogers was Chief Investment Officer. Welton and Rogers argue that an active strategy is superior to a passive one, especially when a portfolio is state-specific. We could not agree more.

Though the article provides a fairly exhaustive analysis of the difference between active and laddered portfolios, we thought there were a few key points that clarify the major areas in which an active manager adds value: Preservation of Principal, Opportunity Costs, Market Inefficiencies and Tax Efficiency. Preservation of Principal has always been a cornerstone of the Caprin process, our name being derived from the words Capital Preservation and Income. Active managers think of capital preservation in two forms: Price while the bond is owned and Price in the event liquidation is required. Active managers apply ongoing credit research and knowledge of historic credit spreads to each bond owned or considered for purchase with the goal of insulating portfolios from unnecessary fluctuations in value. By maintaining portfolios of attractive bonds, active managers “mitigate the risk of capital loss by eliminating bonds that may fall greatly in price.”

Non-Government Bond markets, and especially the municipal bond market, are inefficient at best, and those inherent inefficiencies present either opportunity or opportunity costs to all bond investors. “An active bond manager is able to take the lessons from historical market movements as well as an understanding of the buyers and sellers in the marketplace to generate added value to the portfolio.” Active managers add value through duration management, yield curve positioning, sector allocation, and security selection.

Through duration management active managers execute swaps into bonds that will perform better in rising or falling interest rate environments. If interest rates are rising, active managers will rely more heavily upon bonds with higher coupons and shorter maturities. Conversely, when interest rates decline, active managers can purchase bonds that will maximize the opportunity for a bond's value to appreciate. Examples include zero coupon bonds and bonds with longer durations.

Yield curve positioning is another area for opportunistic value adding. Welton and Rogers assert that, "because laddered portfolios are always structured the same way . . . they cannot benefit from changes in the yield curve the way an actively managed bond portfolio could." Active managers "anticipate changes to the yield curve . . . and can move in and out of bonds that can benefit from their forecasting." Additionally, active managers add value to portfolios by employing different overall structures to the portfolio: barbell, bullet or a ladder.

Active managers also take advantage of temporary market imbalances that can exist between sectors and states. Because the active manager is always watching the markets and knows historical spread relationships between sectors and states, "when they see spreads significantly different from historical spread, they will rotate sector positions of movement back to historical values. . . . Whereas the laddered bond portfolio makes no trade, it loses out on the opportunities, no matter how long the disparity in spreads."

Because active managers are always in the markets, active managers add value over a laddered municipal bond portfolio by recognizing when a specific bond is mispriced and purchasing that bond below its "fair" value. An active manager can unlock hidden value in several ways, including "analyze and understand the value of a bond with a complicated structure, identify issuers and bonds whose credit rating may improve, or find callable bonds that, though eligible to be called, have a high likelihood of not being called." Because laddered portfolios are not actively managed, they often lose out on the opportunity to buy mispriced bonds.

Tax efficiency is perhaps one of the most easily understood ways in which an active manager can add value above a laddered portfolio. Both styles can be used to harvest tax losses by selling bonds that have fallen in price, however, Welton and Rogers help clarify the difference between the ability to harvest those losses. Generally, most laddered portfolios harvest losses only at the end of the year and at the specific request of the client, but "generating tax losses only at year-end leaves many opportunities on the table." The year-end interest rate environment may not be favorable for harvesting tax losses, there could be a supply demand imbalance, and suitable reinvestment opportunities may be sparse. "On the other hand," Welton and Rogers say, "an active manager can continuously harvest tax losses throughout the year." And, "performing tax-loss harvesting throughout the year can provide excellent buying opportunities in November and December when other managers are only starting to look at harvesting losses." They further point out that sometimes, during years like 1994 and 1999, "the tax benefit generated from tax-loss harvesting can more than offset the management fees for several years."

Welton and Rogers conclude, "Though laddered municipal bond portfolios are created with relative ease and intuitive to understand, actively managed municipal bond portfolios can generate more value through a combination of factors: emphasis on total return [this includes income and capital gains], preservation of principal through credit analysis, value added portfolio structuring and risk management, active trading, tax management techniques and lower fees. . . . We believe that when an investor is deciding upon a laddered bond portfolio or an actively managed bond portfolio, without a doubt, the investor should choose to have his or her money actively managed."

We couldn't agree more.

These are all ways we add value to client portfolios. Fixed Income is your "sleep at night" investment, and we put the extra chocolate on your pillow.

Thank you for your continued trust in Caprin.