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 2006: Time Changes Everything

While there was nothing particularly different to report to you about the Federal Reserve Board and the macroeconomic backdrop in our last newsletter, we quickly changed gears in July to take advantage of higher yields that finally presented themselves. The Fed decided to break the trend of their prior 17 consecutive meetings and held the Fed Funds rate at 5.25% on August 8th. At their September 20, 2006 meeting, they once again held rates unchanged.

Consequently, a new environment has developed in which the capital markets are indicating that an economic slowdown may tip the US economy into a recession. Focus has shifted from inflationary fears to economic decline. We don't believe a recession is particularly likely, but consumer spending has been stretched under the weight of energy prices and the slowing of home equity extraction. Often it takes time for the consumer to regain spending momentum, and the upcoming holiday season should be telling.

The Fed pause, declining oil, gas and commodity prices, and the prospect of a slower economy prompted yields to fall and bond prices to rise during the third quarter. Ten year treasury rates dropped from a high of 5.25% on June 28th to a low of 4.54% on September 25th. The speed and strength of this decline caught many market participants by surprise, continuing through quarter end with little regard for the "substantial risk of inflation" message many Fed governors espoused. While we continue to forecast lower rates in 2007, we expect 2 to 30 year interest rates to move modestly higher in the short term as the market 'corrects' itself from this strong third quarter move. We will take advantage of opportunities during these volatile times to capture higher yields now and increase average maturities so portfolios can retain value in anticipation of lower interest rates next year.

Municipals

Over the last two years while the Fed was steadfastly raising short-term interest rates, we were very cautious with client assets, owning more short maturity securities than those held in a typical portfolio with average maturities of 3 to 5 years. The evolving market environment of the third quarter reinforced our decision to maintain a duration target of approximately 3.8 years at our July investment committee meeting. We viewed this target as "neutral" since we believed rates were not likely to increase substantially even though they were not yet making a definitive transition to lower levels. By our August committee meeting, though, evidence had mounted that the transition period we had expected and discussed was beginning to unfold, and as such, we elected to increase our portfolio target to 4 years and to favor longer maturity bonds.

Third quarter portfolio activity focused on securities maturing in 2013-2017. We employed this strategy because these longer maturity bonds provided higher yields and the opportunity for greater price appreciation than shorter maturity bonds. For many clients, our strategy of holding short-term maturities during the first half of 2006 enabled us to capitalize on these investment opportunities as they presented themselves. Additionally, we executed select swap strategies selling bonds which had appreciated incrementally and using those proceeds to lock in higher yields.

Year-to-date (9 months) total returns for our composite are over 2.9%, which is predominately, if not entirely, tax free. The taxable equivalent of this return is 5.4% using the 35% Federal tax bracket. These returns have been driven by the opportunity to capture higher yields following the rate increases of the first half of 2006 and a gradual move to longer maturity bonds in the third quarter providing for some modest price appreciation.

maintain ZIRP (zero interest rate policy). This bias toward higher rates could slow global growth, leading to fewer foreign purchases of US Government debt. And with less demand for US bonds globally, interest rates will have to rise to entice buyers. Energy prices remain a major wildcard in the outlook for long-term interest rates. Higher oil prices are approaching the fine line where they are considered either inflationary or capable of tipping the economy into a recessionary slowdown.

Balancing the scales of heightened inflation pressures and a slowing economy has us considering external events that may cause interest rates to fall. Three primary areas could produce these results: First is a significant economic slowdown, causing the stock market to retreat. Second is the likelihood for continued conflict in the middle-east and a potential expansion of that conflict to nuclear capable nations. Third is related to natural disasters; hurricane season is upon us, and recent experiences keep these thoughts close to our hearts. Any or all of these events could cause a flight to quality into the US Treasury market, creating more demand and lower interest rates.

Cash Management

Market sentiment over the course of the last three months indicated a transition in both the economy and Fed policy. These transitions rarely unfold in a 'straight line', therefore we invest portfolio assets consistent with our long term goals using our short term assessments to find value.

Early in the third quarter, rates on Cash Management investments provided an advantage over short term alternatives as the market sought a better understanding of the transition. Our efforts, consistent with our longer term view, focused on increasing our portfolio allocations to investments with 1 to 2 year maturities and on improving portfolio yield. We were able to achieve our goals and reduce short term investments to approximately 15% of assets toward the end of July.

August and September found the market pondering the possibility of an early 2007 cut in Fed Funds. Accordingly, rates on new Cash Management investments moved lower as we headed toward quarter end. Because the market has had a history of getting ahead of itself, we were cautious about these levels and sought better rates for our longer maturity investments. The higher interest rates we are seeing early in the fourth quarter are offering the kind of value we seek for additional commitments in the 1 to 2 year maturity range. We will continue to forge ahead toward our goal of lengthening portfolio average maturity and reducing our short term investment positions.

Equity markets

Equity markets posted excellent results in the third quarter. The S&P 500 advanced almost 6%, bringing its year to date return to 8.5%. Commodity prices, interest rates and inflation were a concern early in the quarter, but these headwinds diminished as the months passed. With 17 rate hikes, it appears the Fed may have successfully contained inflation as evidenced by declining commodity index prices down almost 20% at one point this past quarter. Those equity investors who did not sell this summer were rewarded with the markets positive sentiment about lower interest rates and lessening inflationary pressures.

Currently large cap growth stocks are out of favor. In relation to small cap value and growth stocks we seem to have approached an inflection point where the relative price difference between the two sectors is too large. We expect over the next year that the economy will slow and the earnings of the world's largest and, in most cases, best companies could look spectacular relative to small cap companies. Since 2000, earnings from large cap companies have increased even though their equity share prices in many cases have declined. We believe we are entering an environment which is more favorable to large cap companies, and equity investors should stay the course with patience during periodic shakeouts that may surface.