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.

Capital Preservation & Income

William W. Flowers
President

Cheryl L. Page, CFA
Managing Partner

Edwin B. Horner, III
Managing Partner

Mark B. Sisisky
Managing Partner

Michael L. Hoover, CFA
Managing Partner

Adam S. Plotkin
Managing Partner

R. Preston Nuttall, CFA
Director of Cash Management

Suzanne S. Harris
Partner

Jon R. Tumler
Senior Vice President

Scott S. Miller
Senior Consultant

Ashley E. Griffin
Assistant Portfolio Manager

Peyton M. Studebaker
Assistant Trader

Alice Cole Moss
Marketing & Portfolio 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
1022 Court Street
Lynchburg, VA 24504
ehorner@caprinbonds.com

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

Chevy Chase
Tel. (301) 951-8851
Fax (301) 907-7572
8506 Lynwood Place
Chevy Chase, MD 20815
jtumler@caprinbonds.com

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Municipal Bond Overview:

The second quarter of 2005 began after a significant rise in interest rates that started in late February. The rise ended abruptly, coinciding almost perfectly with the beginning of April. Throughout most of the quarter, 10 year and longer maturity rates declined and the Federal Reserve continued to push short rates higher. (Chairman Greenspan referred to this phenomenon as a "conundrum".)

One seasonal factor that the municipal market experiences is a rise in short-term rates coincident with tax time each year. Within a week of April 15th, tax-exempt floaters often earn some of the highest rates of the year. This seasonal factor continued longer this year than historically evident, lasting until mid-June. Over the last two weeks, however, we have seen short-term rates drop nearly 50 basis points.

It has been difficult to decipher all of the data that has been released and the market's reaction to it. Fundamentally, inflation remains low, though at a significantly higher level than two years ago and the domestic market continues to grow. Consequently, we do not believe that we should see a significant rally in long-term bonds, and we see the Fed remaining vigilant in its efforts to remove the accommodation from short-term rates. While volatility may be high over the next 12 months, we don't necessarily see rates much different than they are today.

During trendless times like these, our position of being in the fixed income market daily provides us the opportunity to evaluate short-term momentum changes and allows us to change holdings to take advantage of these short-term trends for longer-term positioning and yield capture.

On some occasions it helps to incorporate new information even though this newsletter is more about what has happened in the last quarter. As we have described, the bond market has been directionless, continues to trade within narrow ranges, and it will probably take a significant external event to move the bond market out of its range. On July 7th we had an event that did make a substantial change even though the effect hasn't lasted. With the four bombings in London, the US bond market experienced a flight to quality. We do not plan for terrorist attacks, but we do recognize potential impact foreign activity might have on our fixed income markets. Whether we are discussing large foreign ownership, dual deficits, or international growth and inflation prognoses, all have a considerable impact on why fundamentals alone do not determine the current level of interest rates.

Without a surprise reason for rates to change dramatically, we will look for opportunities to lengthen portfolios to be neutral to our intermediate benchmark. The municipal bond yield curve is relatively steep compared to the US Treasury curve, offering opportunities to invest in 10-year bonds at 90% of Treasuries. We continue to purchase premium (high coupon) bonds that will withstand interest rate rises better than par bonds.

Cash Management:

As expected, interest rate actions by the Federal Reserve Board during the 2nd quarter remained consistent with the Board's approach since June 2004, raising rates by 25 basis points per meeting. Two increases were posted again, bringing the Fed Funds Rate to 3.25% as of June 30, 2005, up a full 2.25% since the Board changed policy in June 2004.

Much of the Fed's policy has been driven by an economy that also is progressing "at a measured pace." Growth remained relatively strong through the first quarter of 2005, but was not without some hints that it may slow in future quarters. As the 2nd quarter ended, we continued to closely monitor the implications of the high and increasing costs of energy, the excesses in the housing market, and the general ability of U. S. consumers to continue their consumption habits. The economy and the Federal Reserve are clearly confronting issues which are inflationary historically but which also may lead to slower growth. All of these present conflicts for monetary policy. Should the Federal Reserve Board continue raising rates and gradually slow the economy and the frenzy in the housing market? Or, should they stop raising rates and risk higher levels of inflation and allow continued real estate speculation via low cost financing?

We believe that the Federal Reserve will maintain its present course for the balance of 2005, bringing the Fed Funds Rate to a "neutral" position in the 3.5%-4.0% range by year-end. At that point, the Fed is likely to adopt a wait-and-see posture to properly gauge how the economy has responded to its 18 month monetary policy.

During this period of steadily increasing rates, we have purchased very few longer term investments (12 months+) and opted to raise our allocation to investments with 30 to 60 day maturities. Most portfolios have a strong core of maturities through year end 2005 to complement this short term position. As we have written in prior quarters, this strategy has been designed to allow portfolio yields to increase with increasing short term rates with the knowledge that these higher rates would be locked in as rate increases start to slow. With this approaching, we anticipate selective investing over the next quarters in 12 to 18 month maturities, in anticipation of a leveling off of interest rates.

Equities:

On July 14th the Standard and Poor's 500 Index achieved a four year high in price. A firmer US dollar, healthy but moderating US economic growth, and a weakening global economic picture have created an interesting environment for equities. Volatility in the markets is low and random exogenous events (i.e. the London bombing) do not cause a panic in the markets as investors have learned to live in a world full of uncertainty.

The other side of the coin suggests significant investor complacency. Two major Wall Street firms have a zero allocation to bonds and cash and have steered clients towards a 100% equity exposure. This complacency suggests investors expect earnings are and will remain just fine, and the risk premium investors associate with equity exposure is benign at this time and, more importantly, will remain so in the future. At Caprin, we are realists and know two things. First, bonds have shown how important they are in an investor's portfolio in that they provide stability. Second, as long as the credit of the issuer is sound, we know your loans to these bond issuers will be repaid on time and at par. On the other hand, equities are very long duration assets subject to a myriad of uncertain and unforeseen stimuli which will constantly affect investors' collective judgment as to a security's correct price.

Although we remain bullish long term on high quality businesses, for the time being we believe high liquidity at the margin has driven equities higher, and there is a need for some time to pass to allow earnings to catch up to current stock valuations.

Quality Improvements:

Four years ago the United States was in a recession that led to burgeoning budget deficits for practically every state. If you recall, Governor Schwarzenegger was elected by stating there would be some difficult decisions made regarding California's recklessly expanding deficit. Many states were put on "watchlist" or were downgraded by the nationally recognized rating agencies of Moody's and Standard and Poor's.

Within our footprint, Virginia has now been removed from the watchlist, North Carolina is on watchlist positive after having been downgraded by Moody's in 2003. The District of Columbia has been upgraded from A- to A by S&P, and the list continues with most states better off now than two years ago. Virginia's general fund grew at the fifth-fastest rate in the country during the first quarter of this year. Employment and personal income growth have boosted income-tax receipts 14% so far this year. Income taxes on corporations are the fastest-growing piece of the pie, with anticipated revenue of $549 million. In the first 11 months of this year, corporate tax collections are 50% higher than last year.

This improved credit quality should give great comfort to our municipal bond clients and also speaks highly of the management by many of our municipality clients. A watchful eye on credit quality is one way we continually manage portfolios and add value.