Caprin Asset Management, L.L.C.

Caprin Asset Management's disciplined investment process is dedicated to helping investors navigate the complexities of the municipal bond market by preserving and enhancing investor wealth through thoughtfully constructed, professionally managed portfolios.

July, 2003

Market Discussion:

The second quarter of 2003 turned very positive for the bond markets. After what appeared to be a successful outcome to the war in Iraq, attention turned to a sluggish domestic economy with unemployment rising to 6.4% in June. The Federal Reserve Board of Governors placed less emphasis on shoring up the US Dollar and determined that an additional cut of a ¼% in the Fed Funds Rate was needed to boost the economy. With that action and the possibility of a double dip recession, yields on the 10 year Treasury bond dropped to the lowest level in 45 years to 3.07%.

We may be approaching a long-term turning point for yields. Many investors and traders had anticipated a ½% rate cut in June by the Fed, but the ¼% reduction received a negative reaction in the marketplace creating a bias towards higher yields. During the second quarter, stock prices began to rise as investors began to have faith in a corporate recovery. Many investors shifted away from money market funds with nearly zero returns and re-entered the equity market. Internationally, money repatriated back to Japan.

While there is still the possibility of retrenchment to lower yields, we believe that the next significant movement in interest rates is to higher levels. Although we clearly have been early in this belief, the move to higher yields now appears to be taking place. We do not expect to see a straight line sell-off, and we view the next several months as an opportunity to re-position portfolios to capture unrealized gains, maintain a short duration, and maximize reinvestment opportunities.

A Discussion of Premium Bonds:

Our current investment strategy includes the purchase of Premium Bonds. In light of this strategy in today's historically low interest rate environment, let's discuss the ramifications of owning premium bonds. Mathematically, there is a direct correlation between a bond's coupon and the yield at which it trades for that specific maturity. If the offering yield is lower than a bond's stated coupon, the extra money it costs above 100% (par) is called the premium. If you hold the bond until maturity, you will receive only the face value back in the form of principal. But over the entire life of the bond, you will receive a level of income exceeding the actual purchase yield. This approach benefits clients who reinvest their total interest income as well as those that draw interest from their accounts. In the case where a client takes income, we suggest only distributing income based on the actual yield when the bond was purchased. That acts as a safeguard against spending the additional "premium" that was paid at the time of purchase. As a general rule, we think this is an appropriate strategy to capture additional income in today's low rate environment and reinvest that money at higher rates.

There are also tax considerations related to premium bonds. If purchased at a premium, the cost basis is amortized over the life of the bond. The idea is that there should be no tax consequence if a bond is held to maturity regardless of the purchase date or price. Therefore, on your statement you may see a "write down" of the cost basis on premium bonds. This doesn't mean your return is negative, it simply reflects an adjustment to the cost basis paid to you in the form of higher income.

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