FIXED INCOME
COMMENTARY LETTER
SECOND QUARTER 2005

Overview

- The bond market rebounded in the second quarter after slightly negative returns in the first quarter. Price strength was broad across the yield curve, but most pronounced for longer-duration securities.

- The market's favorable reaction to the Federal Open Market Committee's (Fed) continued rate hikes surprised many analysts. Late May witnessed revised and lower year end Treasury yield forecasts at several major Wall Street firms.

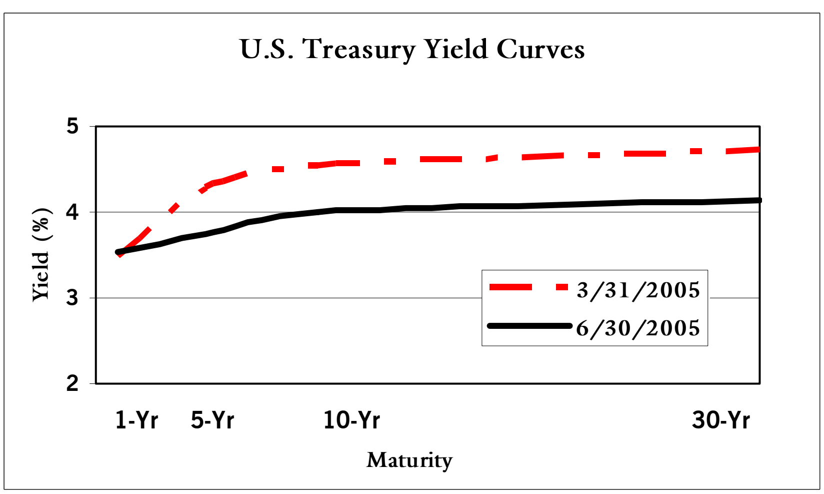
- While the dollar strengthened versus most currencies, net foreign purchases of U.S. securities trended higher during the quarter. Strong overseas demand for our securities is often characterized as unsustainable and likely to lead to higher rates in the future.

Interest Rates

- The Lehman Brothers U.S. Aggregate Bond Index returned 3.01 percent in the second quarter after a negative first quarter index return of (0.48) percent.

- As was the case in the first quarter, the Fed raised its target for the federal funds interest rate twice, bringing the rate to 3.25 percent. This is the ninth 0.25 percent increase in the last year. The Fed continued to use the term "measured" to describe the pace of rate increases, and analysts have now turned their focus to predicting the end to this series of rate hikes.

- The yield curve flattened during the quarter as the difference between short-term rates and long-term rates narrowed (see chart below). Several reasons for this uneven rate movement, aka Greenspan's "conundrum," have been suggested, and include a shortage of long-duration securities in the face of rising demand by pension funds. This perceived shortage led the Fed to announce that it was considering reinstituting the auction of 30-year bonds in February 2006, and coincides with similar plans at several European government issuers.



Sector Updates

- U.S. Treasuries were the strongest performing sector for the quarter returning 3.63 percent compared to a Lehman U.S. Aggregate return of 3.01 percent. The Treasury sectors leading performance was driven entirely by the long-duration component, which returned 7.7 percent. The Intermediate Treasury component returned 2.32 percent.

- The U.S. agency sector lagged the broad index and the Treasury sector primarily due to its shorter average duration. For the quarter, this sector returned 2.74 percent.

- The House Financial Services committee passed draft legislation to create new oversight for government agencies (GSEs). Improved oversight should lead to improved credit quality at the major issuers.

- The corporate sector recovered from its dismal first quarter, returning 3.58 percent. Year-to-date, the sector has returned 2.49 percent. Within the sector, industrial issuers only slightly outperformed financial issuers. This was surprising, as analysts generally expect financial companies to do poorly in a flatter yield curve environment.

- The corporate sector witnessed the double credit downgrades of Ford and General Motors to junk status. This moved $85 billion of debt into the $600 billion junk bond market—the largest index transition in history.

- Mortgage-backed, fixed rate securities lagged the broad index and other spread sectors, delivering a return of 2.27 percent for the quarter. Within the sector, Ginne Mae's (GNMA) 15-year securities were the top performers. Mortgage-backed investors were buffeted by concerns over the housing cycle and the pre-payment risks that accompany unexpected downturns in interest rates.

- Municipal market fundamentals, including supply, credit quality, and valuation measures, remain favorable at quarter end. The chart below illustrates the increasing yield of municipal bonds versus Treasury bonds. A higher ratio implies favorable relative valuation for municipals and broader appeal for investors with incrementally lower federal tax rates.

Municipal / Treasury Yield Comparison		
12/31/04	3/31/05	6/30/05
83.5%	85.4%	88.1%

Source: Municipal Market Data

- The Lehman Municipal 5-Year Index returned 1.91 percent. At a 35 percent tax rate, this equates to a 2.93 percent taxable equivalent return, which is competitive with other low duration market sector returns.

Looking Ahead

- During the quarter, bonds were dubbed "The World's Most Hated Asset Class" by Merrill Lynch after placing last in their Fund Manager Survey, which asked managers to rate the best and worst performing asset classes over the next twelve months. From a contrarian's perspective, this remains a bullish technical indicator.

- The declining correlation between stocks and bonds in 2005, as measured by the S&P 500 and the U.S. 10-Year Treasury, should improve the diversification value of fixed income securities in balanced portfolios.

- Attention is starting to surface on a growing demographic demand for bonds and income-producing assets in the U.S. According to the Fed's latest Survey of Consumer Finances from 2001, bond holdings for U.S. households decreased to 4.6 percent from 8.4 percent in 1992. At the same time, the percentage that stated they are now gearing their savings towards retirement rose to 32.1 percent from 19.4 percent. This suggests growing demand for fixed income assets going forward.

- A domestic economy that is characterized as being in a 'soft landing,' with decelerating consumer inflation and favorable supply trends all support bond prices in spite of continued Fed rate hikes. Non-financial U.S. corporations had negative net borrowing in 2003 through 2004, and current borrowing needs remain near zero. The recent $100 billion reduction in the country's budget deficit also reduces future supply from the government sector.

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