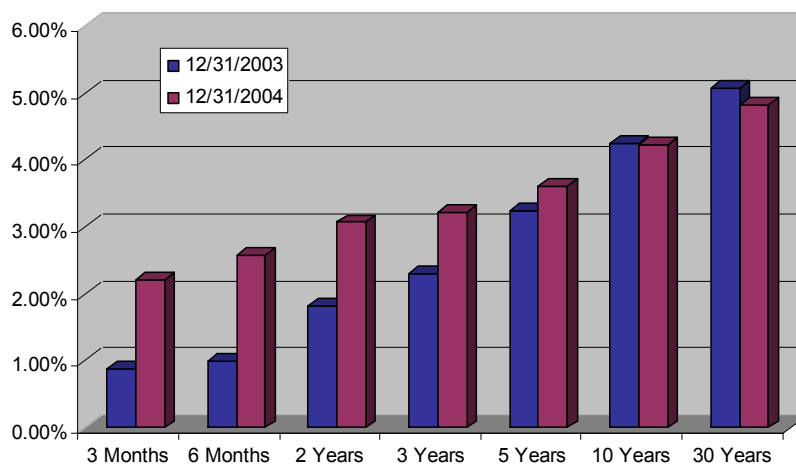


2004 U.S. Bond Market Recap

2004 turned out to be a stirring year for the U.S. bond market. Precedents were ignored. The Federal Reserve raised the short term interest rates, the value of the dollar plummeted, oil prices soared and the bond market thrived albeit with some volatility in late spring and early summer. The slope of the Treasury Yield Curve flattened, meaning that the difference between short-term and long-term yields decreased. Five hikes in the Federal Funds rate, coupled with a fall in rates at the long end of the bond curve, led to this flatter curve. Short-term rates increased considerably, while the Benchmark 10-Year Treasury Note yield was little changed. Yields on 3 and 6 month Treasury-Bills have increased 1.32% and 1.59% respectively. The 10-Year Treasury Note began the year yielding 4.25% and ended at 4.22%, down 3 basis points. This was a surprise to most people in bond land.

About this time last year, 60 economists were polled by Business Week and the consensus was that the yield on the 10-Year Treasury bond would increase 75 basis points to 5.00% by the end of 2004. Only two called for a yield of under 4.40%. We have come to expect the unexpected.

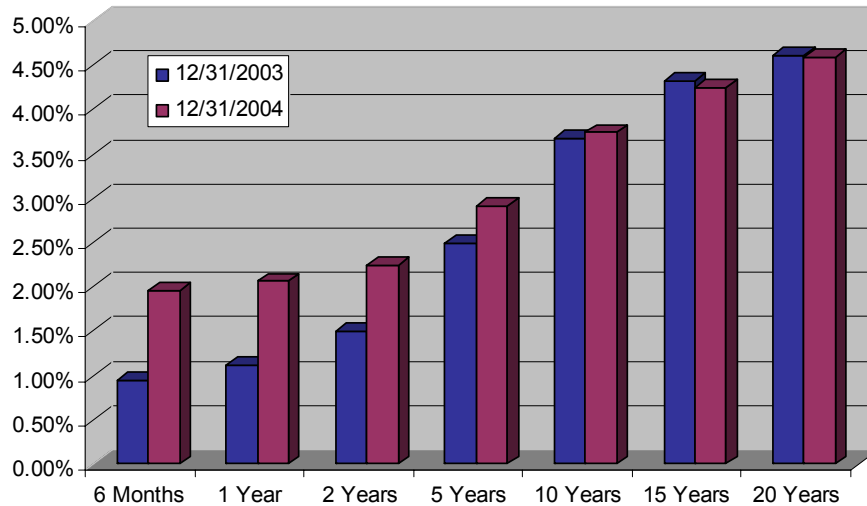
U.S. Active Treasury Yields



U.S. taxable fixed income funds returned an average 4.54% in 2004 according to Lipper Inc. The average insured municipal fund returned 3.21%, while the average short-intermediate municipal fund returned 1.63%*.

Municipal bond yields followed a similar path to the Treasury yields for 2004. For this report we will use the Bloomberg US Municipal General Obligation AA+ index as a proxy for municipal bond rates. The yield curve for this index flattened along with the Treasury curve. The Bloomberg Fair Value for 1 year AA+ rated General Obligation Municipal bond was up 0.94% for the year ending at 2.06%. The Bloomberg Fair Value for the 5-year municipal bond increased in yield by 0.42%, ending the year at 2.91%. The 20-year bond fair value decreased in yield by 0.02%, from 4.61% to 4.59%

Bloomberg U.S. Municipal General Obligation AA+



The flattening of the yield curve was the story of the year. Municipal bond yields are slowly returning to their historical relationship with Treasuries as state and local government budget deficits fade as a result of the improving economy. As oil soared to record levels, the bond market rallied. Higher oil prices point to a weaker overall economy, which puts downward pressure on interest rates. Crude Oil Futures had a very volatile year with a low of \$32.48 on 2/6/04, hitting a high of \$55.17 per barrel on 10/26/04, and finally retreating to end the year at \$43.45.

U.S. Monetary policy was center stage 2004. The Federal Funds rate began the year at 1.00% and stayed there for the first half of the year. Since June 30, 2004 the Federal Open Market Committee has increased its target for Federal Funds by 0.25% each meeting, ending the year at 2.25%. These rate hikes led to bond yields increasing on the short end of the curve.

What does this mean for your current bond portfolio?

We are reminded of the adage, “slow and steady wins the race.”

Slow and steady is our approach to managing bond portfolios. We too were surprised that long-term interest rates did not increase in 2004. But we avoided the mistake made by many of our colleagues in 2004 and counseled our clients to stay near fully invested. Maintaining a high balance in low yielding money market funds proved costly to many investors last year. Our philosophy remains to stay nearly fully invested in a laddered portfolio looking for value added swap opportunities during the year as a way to increase portfolio performance. The approach is time-tested and it has worked well for our clients for many years. We quit trying to predict interest rates a long time ago. We recommend finding better than average bond values in the section of the yield curve that is attractively priced.

In general, with yields up significantly on the shorter term bonds (<5 years) the value of existing short term holdings decreased in value. Remember that the passing of time offsets this loss in value caused by higher interest rates so that the net effect on the portfolio was minimal. The intermediate and long-term bond valuations have experienced slight changes, if any, as a result of changes in interest rate levels.

Hopefully, this recap has been helpful in understanding events that shaped the bond market in 2004. Thank you for continued confidence in our bond research and portfolio management process and we look forward to working with you in 2005.

Sincerely,
Ronald P. Bernardi, President
Bernardi Securities, Inc.

**Source: NASDAQ listed open end general municipal funds*

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