Dresdner RCM Global Investors

Quarterly Investment Strategy Sheet

Fourth Quarter 2000

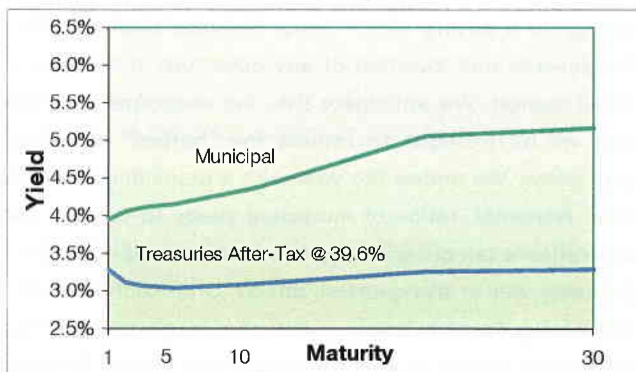
U.S. Tax-Managed Fixed Income

▶ Market Environment

For the first time in five years, bonds enjoyed the performance spotlight returning over 13% for the year, as measured by the Merrill Lynch Treasury Index. The strong rally during the final quarter of the year reflected investors' desire to flee equities in favor of the relative stability of bonds. In addition, market participant expectations intensified regarding the prospect of an economic slowdown resulting in Federal Reserve rate reductions. While money flowed into bonds across all maturities along the yield curve, intermediate Treasury maturities benefited the most, as investors anticipated the reshaping effect of an initial Fed easing. As the graph below illustrates, the yield curve changed dramatically, both in terms of the level of rates and its shape. The general decline in Treasury rates has brought yields to their lowest levels in almost two years. The closely watched 10-year Treasury Note yield fell almost a full percentage point from 5.8% to 4.9%, easily piercing the magic 5% level for the first time since the fall of 1998. Municipals also had an excellent year, as 10-year AAA municipals fell by 70 basis points.

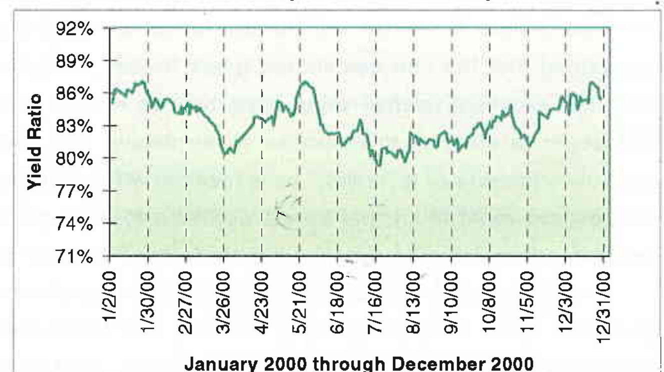
Early estimates for growth in the fourth quarter are already shaping up to be lower than the third quarter based on a lackluster holiday shopping season and a dramatic slowing in employment gains. Inflation fears remain subdued with November's CPI at 0.2%, though the core CPI (which excludes food and energy prices) did tick up slightly to 0.3%. Unemployment rose to 4.0% in November from its 30-year low of 3.9%. Energy prices (especially natural gas) remained high. With forecasts of a cold winter, scarce inventory, and continued harsh weather across most of the country, in general, the market expects prices to be supported at or above current levels. Factory orders declined 3.3% after the previous 1.6% gain, and the University of Michigan consumer sentiment index dropped significantly from 107.6 to 97.4, indicating consumer expectations for future economic growth have downshifted. Weakening activity has also been evident in other major economies, intensifying expectations of a global slowdown.

Municipal and After-Tax Treasury Curves
December 29, 2000



Source: Dresdner RCM Global Investors

Ten-Year Municipal/U.S. Treasury Ratio



Source: Datastream

▶ Portfolio Review

With the volatility of the treasury and municipal markets, we were able to exploit a number of "ratio trades" throughout the year. The ratio of municipal to treasury yields can be used to indicate the relative value of municipals to treasuries. The higher the ratio, the more attractive the municipal market is relative to the Treasury market. Since

municipals tend to lag in strong market moves, we were able to exploit the relative shift in values between the two types of securities. Over the year, we owned slightly more taxable securities than we typically would, as we believed that the government program of buying back Treasury debt increased the attractiveness of the securities.

In the fourth quarter, with the data increasingly pointing to an intensifying economic slowdown, our belief was that the Federal Reserve would adopt an easing bias (as was confirmed on December 19) and accelerate the market's expectation for rate cuts early in 2001. Anticipating that outcome, we moved portfolios to a modestly long duration posture early in November. The decision paid off, as rates across the entire curve declined, and positive relative performance was realized. With expectations that the Treasury yield curve would steepen (i.e., the most significant rally would be on the short end), we placed our taxable security exposure in two- and three-year maturities. We purchased agencies as they offered value relative to more richly priced Treasuries. As intermediate and short rates fell in response to the events noted above, this position also added to performance. In contrast, the municipal yield curve flattened ending the year at levels close to the flattest of the year. This occurred because investors were willing to move purchases out along the maturity curve in an effort to buy higher yielding securities. Additionally, firms with municipal derivative programs (which buy longer-dated municipals and strip the coupon into short, money-market securities) were very active, and drove down longer-dated securities with their heavy demand. We benefited from this as we held a moderate barbell in our municipal exposure. Our emphasis on high quality and specialty state issues (which are bonds heavily demanded largely because they offer double tax exemption to in-state residents) also added to performance. Since we owned only highly rated securities (A or better, with a solid AA portfolio average), we were not hurt by the slight widening that occurred between BBB and AAA rated credits.

Despite the fact that the portfolios consisted of large unrealized gains, due to declining yields, we added significant value to the portfolios using our tax management plan. Generally, we only executed strategies with attractive after-tax return expectations to minimize the amount of gains realized. We continued our emphasis of owning securities with a strong tax-advantage (those offering federal and state tax exemption) with the exception of California. Our analysis of the market for California securities is that it is better to own the out-of-state paper and pay the state tax than own the richly priced California bonds.

▶ Outlook

Both the new year and the first quarter started with a bang, when on January 3, the Fed, in a surprise move between official meetings, cut the fed funds rate by 0.5%, setting off a strong rally in most financial markets. We are convinced that the Fed has shifted gears toward mitigating the severity and duration of any downturn in the economy and that excellent relative-value opportunities remain in the bond market. We anticipate that the municipal yield curve will begin to steepen in response to an easing Fed. As such, we have begun to reduce the "barbell" structure of portfolios to more of a "bullet," as is feasible without taking large gains. We ended the year with a municipal overweight and believe most municipal bonds continue to offer good value. Recently, ratios of municipal yields to taxable yields are very attractive although the ultimate form of the new administration's tax cut will keep the muni market in check.

In summary, we expect bonds to continue to perform reasonably well in the quarters ahead. Until such time as the economy again starts to pick up and the Fed takes away the easing "punch bowl", rates should continue to drop, especially in the shorter maturity end of the U.S. yield curve. We do not expect to see any meaningful pickup in inflation although the recent weakening in the dollar relative to the euro could remove one of the key elements that has helped keep inflation consistently low the past several years.