

FIXED INCOME PORTFOLIO

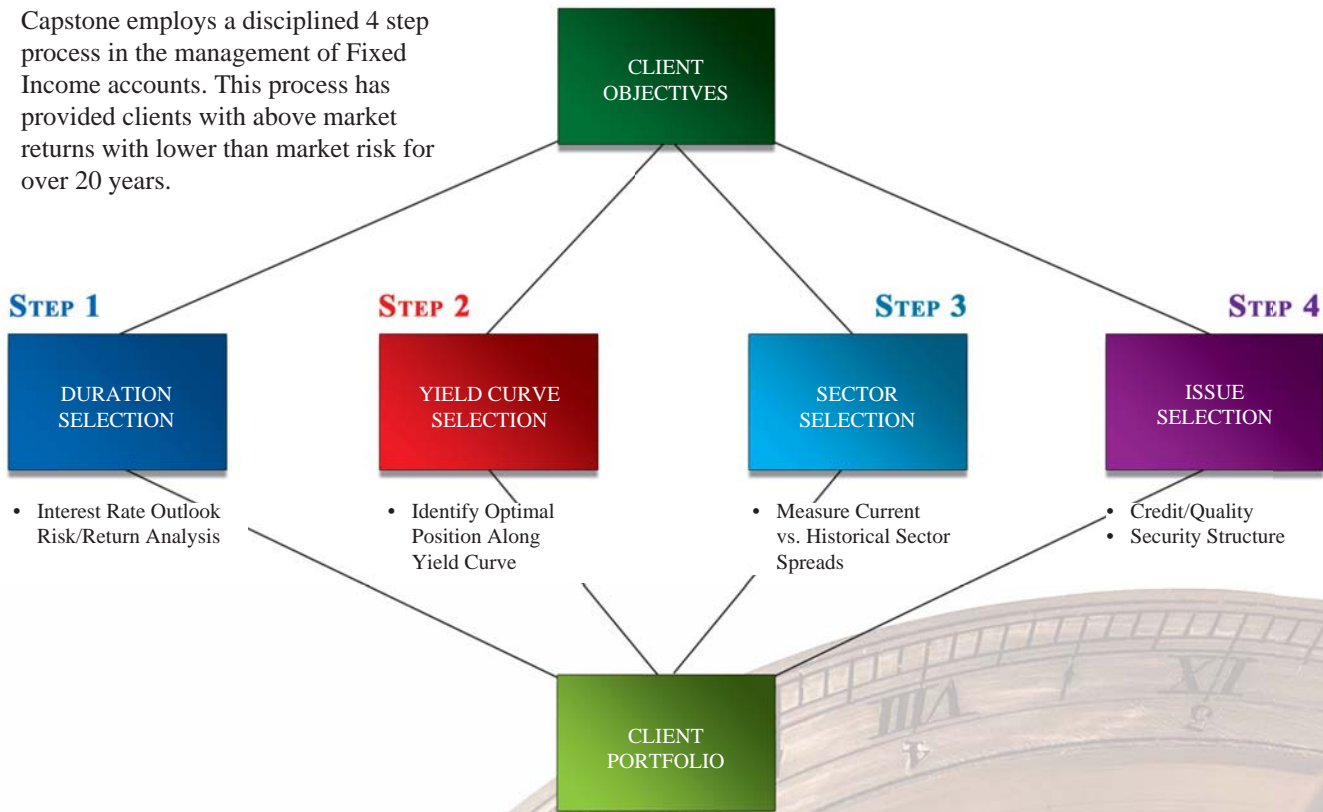
Portfolio Objective:

To provide income and capital appreciation together with capital preservation through the management of high quality domestic bonds.



FIXED INCOME PORTFOLIO INVESTMENT PROCESS

Capstone employs a disciplined 4 step process in the management of Fixed Income accounts. This process has provided clients with above market returns with lower than market risk for over 20 years.



Why Active Bond Management?

Active Bond Management is a portfolio strategy of managing assets by continually repositioning portfolios to take advantage of the most favorable opportunities.

- Takes advantage of bond market inefficiencies
- Portfolio is adjusted when opportunities arise and when market conditions change
- Duration management = risk control
- Active decisions are made to properly weight the portfolios by sector and credit diversification
- Application of yield curve strategies
- Application of sector rotation
- Specific security selection adds value
- If interest rate declines are anticipated, managers can increase portfolio duration (and vice versa)

Active Management Techniques

Capstone optimizes opportunities and seeks to avoid pitfalls as they are identified.

- Changes in the level of interest rates
- Changes in the shape of the yield curve
- Changes in yield spreads across and between sectors
- Changes in relative value of individual investments

PORTFOLIO STRATEGY

Capstone's Fixed Income Portfolios offer investors a separately managed account consisting primarily of intermediate-maturity, government, agency and corporate bonds. Our fixed-income approach is based on the belief that superior long-term returns can be achieved with less-than-market risk by focusing on high quality securities, and by adding value through active duration management and the selective rotation of market sectors and the securities within those sectors.

Step One: Maturity Selection

The process begins with an analysis of the domestic and international economies, the political environment and the current state of the credit markets. Based on an analysis of these variables, an interest rate outlook is established. Maturity is then determined which is designed to maximize return and minimize risk.

Step Two: Yield Curve Selection

Once an average maturity target for the portfolio is established, a decision is made as to the allocation of assets along the yield curve which will achieve the targeted average maturity. Discussions and analysis answer questions such as 1) should the portfolio invest primarily in the targeted maturity range (bullet strategy) 2) should the portfolio invest somewhat equally along the yield curve (modified ladder strategy) or 3) should the portfolio overweight in short-term and long-term securities (barbell strategy)? These decisions are based on the current and projected shape of the yield curve in an attempt to identify the optimal mix of maturities that would provide a high level of income adjusted for risk.

Step Three: Sector Selection

Market sectors are now compared to determine which sectors offer the most current value. The primary sectors utilized include: U.S. Treasuries, U.S. Agencies, industrials, finance, banks, utilities, telephones and mortgage-backed securities. Some portfolios may be restricted to particular maturity guidelines, sector constraints or quality limitations to name a few customizations available.

Step Four: Issue Selection

The final step is to select the most attractive issues within the most attractive sectors. Each issue undergoes a thorough quality analysis before it is added to the portfolio. All securities are rated investment grade at the time of purchase, with an average portfolio rating of "AA". Once issue selection is complete, overall portfolio characteristics are monitored for compliance with client objectives and restrictions.

“We establish and maintain dynamic, long-term relationships with clients based on a mutual understanding of overall business objectives, specific investment requirements, joint trust and clear communications.”

BOND TERMS GLOSSARY

Ascending, or Positive, Yield Curve: The interest rate structure which exists when long-term interest rates exceed short-term interest rates.

Bond: The written evidence of debt, bearing a stated rate or stated rates of interest, or stating a formula for determining that rate, and maturing on a date certain, on which date and upon presentation a fixed sum of money plus interest (usually represented by interest coupons attached to the bond) is payable to the holder or owner. For purposes of computations tied in to "per bond," a \$1,000 increment of an issue (no matter what the actual denominations are) is used. Bonds are long-term securities with a maturity of greater than one year.

Bond Swap: The sale of a bond and the purchase of another bond of similar market value. Swaps may be made to establish a tax loss, upgrade credit quality, extend or shorten maturity, etc.

Bullet: A security with a fixed maturity and no call feature.

Call: Actions taken to pay the principal amount prior to the stated maturity date, in accordance with the provisions for "call" stated in the proceedings and the securities. Another term for call provisions is redemption provisions.

Callable: Subject to payment of the principal amount (and accrued interest) prior to the stated maturity date, with or without payment of a call premium. Bonds can be callable under a number of different circumstances, including at the option of the issuer, or on a mandatory or extraordinary basis.

Call Date: The date at which some bonds are redeemable by the issuer prior to the maturity date.

Coupon: The rate of interest payable annually.

Current Yield: The ratio of interest to the actual market price of the bond, stated as a percentage. For example, a bond with a current market price of \$1,000 that pays \$60 per year in interest would have a current yield of 6%.

Duration: The most commonly used measure of risk in bond investing. Duration takes a bond's coupon, yield, maturity and special features into one number to indicate how price-sensitive a bond or a portfolio is to changes in interest rates.

Federal Funds Rate: The interest rate charged by banks on overnight loans of their excess reserve funds to other banks.

Floating-Rate Bond: A bond for which the interest rate is adjusted periodically according to a predetermined formula, usually linked to an index.

High-Yield Bond: Bonds issued by lower-rated corporations, sovereign countries and other entities rated Ba or BB or below and offering a higher yield than more creditworthy securities; sometimes known as junk bonds.

Inverted, or Negative, Yield Curve: The interest rate structure which exists when short-term interest rates exceed long-term interest rates. See "ascending, or positive, yield curve."

Investment Grade: Bonds considered suitable for preservation of invested capital; ordinarily, those rated Baa3 or better by Moody's Investors Service, or BBB- or better by Standard & Poor's Corporation.

Liquidity: The ability to trade bonds efficiently without causing any major changes in their prices.

Maturity Date: The date when the principal amount of a security becomes due and payable, if not subject to prior call or redemption.

Premium: The amount by which the price of a security exceeds its principal amount.

Spread to Treasury: The difference between the yield on a fixed-income security and the yield on a Treasury security of comparable maturity. For example, the spread between a 10-year Treasury yielding 4.75% and a 10-year corporate yielding 5.25% is 50 basis points.

Yield: The annual percentage rate of return earned on a security. Yield is a function of a security's purchase price and coupon interest rate.