

MUNICIPAL FIXED INCOME PORTFOLIO

(NATIONAL AND STATE SPECIFIC)

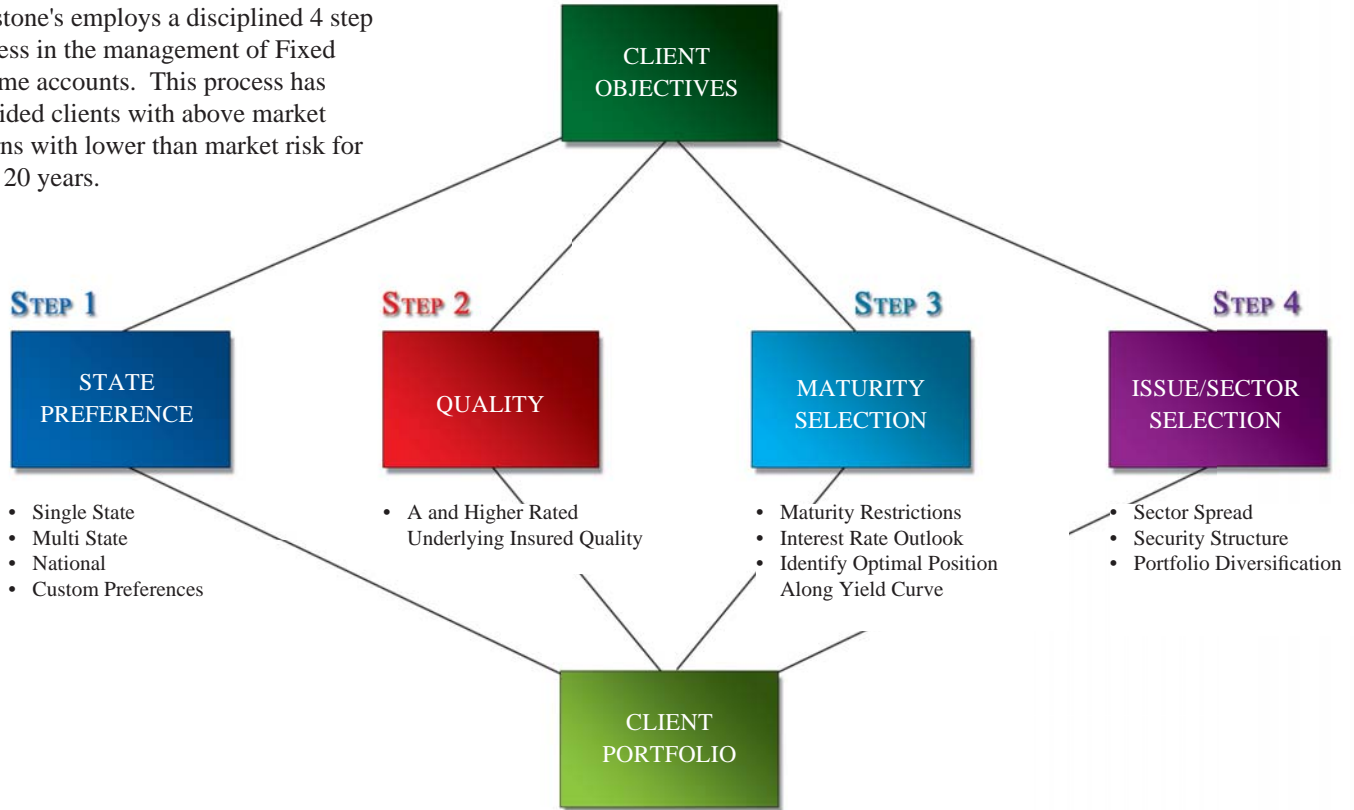
Portfolio Objective:

To maximize after-tax income and preserve capital. We seek to reduce risk levels in portfolios by managing duration and utilizing "A" and higher rated insured bonds, not subject to AMT.



MUNICIPAL FIXED INCOME PORTFOLIO INVESTMENT PROCESS

Capstone's 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.



What Are Municipal Bonds?

Municipal bonds are debt obligations issued by states, cities, counties and other governmental entities to raise money to build schools, highways, hospitals and sewer systems, as well as many other projects for the public good.

When you purchase a municipal bond, you are lending money to an issuer who promises to pay you a specified amount of interest (usually paid semiannually) and return the principal to you on a specific maturity date.

Not all municipal bonds offer income exempt from both federal

and state taxes. There is an entirely separate market of municipal issues that are taxable at the federal level, but still offer a state — and often local — tax exemption on interest paid to residents of the state of issuance.

Why are Municipal Bonds a good investment?

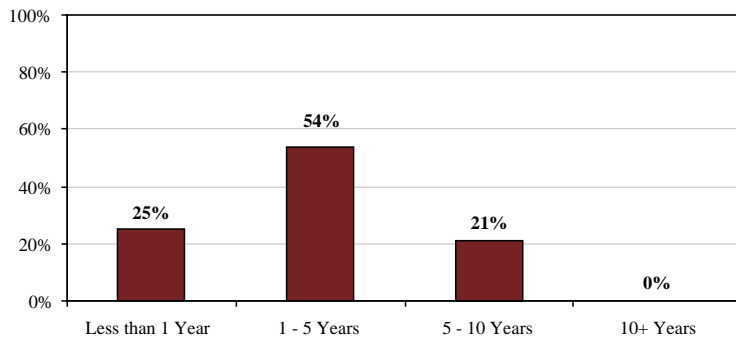
In addition to being largely bulletproof in terms of creditworthiness, most muni bonds are backed with "just-in-case" insurance from one of four main agencies -- Ambac, FGIC, FSA and MBIA. The bonds we choose for you are insured by one of those agencies.

Investment Philosophy

Capstone's municipal bond investment philosophy is based on the following: access to the institutional market provides the opportunity to capture a higher quality inventory of municipal bonds at competitive prices, enabling us to efficiently and actively manage the portfolios. By emphasizing bond characteristics and overall structures, we attempt to maximize the portfolio's coupon income, call protection and tax advantages that drive long-term performance.

Tax-exempt municipal bonds are among the most popular types of investments available today, and with good reason. They offer a wide range of benefits, including:

- Attractive current income free from federal and, in some cases, state and local taxes;
- High degree of safety with regard to payment of interest and repayment of principal;
- Predictable stream of income;
- Wide range of choices to fit your investment objectives with regard to quality, maturity, choice of issuer, type of bond and geographical location; and
- Marketability in the event you need to sell before maturity.



Capstone purchases bonds with maturities in the one to twenty year range. This allows us flexibility to properly manage duration and the best opportunities along the yield curve.

The average duration range is 3-5. This intermediate concentration offers less price fluctuation yet efficient opportunity.

Taxable-Equivalent Yield of Municipal Bonds Based on Various Federal Income Tax Brackets

		Tax-Free Yield (%)								
		3.0	3.5	4.0	4.5	5.0	5.5	6.0	6.5	7.0
Tax Bracket	Taxable-Equivalent Yield (%)									
	10%	3.3	3.9	4.4	5.0	5.6	6.1	6.7	7.2	7.8
	15%	3.5	4.1	4.7	5.3	5.9	6.5	7.1	7.6	8.2
	25%	4.0	4.7	5.3	6.0	6.7	7.3	8.0	8.7	9.3
	28%	4.2	4.9	5.6	6.3	6.9	7.6	8.3	9.0	9.7
	33%	4.5	5.2	6.0	6.7	7.5	8.2	9.0	9.7	10.4
35%	4.6	5.4	6.2	6.9	7.7	8.5	9.2	10.0	10.8	

Example: A taxpayer in the 28% bracket would have to purchase a taxable investment yielding more than 6.9% to outperform a 5% tax-free investment.

The Advantages of Tax Exemption

One of the best ways to appreciate the tax-exempt advantage of a municipal security is to compare it to a comparable taxable investment. For example, assume you are in the 33% federal tax bracket, file a joint return with your spouse, and claim \$175,000 in taxable income.

Now assume you have \$30,000 to invest and you are considering two investment alternatives: a tax-exempt municipal bond yielding 5%, and a taxable corporate bond yielding 7%. Which investment will prove most advantageous?

If you invested your money in the municipal bond, you'd earn \$1,500 in interest (a 5% yield) and pay no federal income taxes. The taxable bond investment, however, would provide you only \$1,407 in income after federal income taxes had been deducted (a 4.7% yield).

Effect Of Federal Income Taxes On Yields Of Tax-exempt And Taxable Instruments

	5% <u>Tax-Exempt Bonds</u>	7% <u>Taxable Bonds</u>
Cash Investment	\$30,000	\$30,000
Interest	\$1,500	\$2,100
Federal Income Tax in the 33% Marginal Tax Bracket	\$0	\$693
Net Return	\$1,500	\$1,407
Yield on Investment After Taxes	5%	4.7%

As you can see, the municipal bond would provide the best yield after taxes are taken into account. The tax-exempt security would be an even better investment if you accounted for state and local income taxes when calculating returns on the taxable bond investment.