

It appeared to make sense to describe in writing Midland's approach advising client's on their bond portfolio. Below addresses our philosophy and process as well some historical perspective on bonds and their returns.

SUMMARY

In short our focus can best be summarized below when advising clients on their bonds:

The primary goal of a laddered bond portfolio is to achieve a total return over all interest rate cycles that compares favorably to the total return of a long-term bond, but with less market price and reinvestment risk.

Source: TIM

A HISTORICAL PERSPECTIVE

During the late 1980's and 1990's, investors owning municipal bonds or municipal bond mutual funds with long maturities (greater than 10 years) enjoyed gains averaging over 12% per year. However those periods were when the Federal Reserve was reducing interest rates – consistently. On the opposite end of the spectrum was the decade of the 1950's – considered the worst decade for owners of long-term bonds with investors experiencing an average annual loss of -0.1% (with re-invested interest income).

If you a bond with a long maturity you know what the expected interest payments over the life of that bond. The price of any bond is the present value of this stream of interest payments discounted at current interest rates. As rates fluctuate, the present value of this stream of payments constantly changes. Below is chart showing the difference in average rates of return and the riskiness (standard deviation) of the bond.

SUMMARY STATISTICS OF ANNUAL RETURNS		
1962–2001	Average Annual Total Return	Standard Deviation of Return
Treasury Bills	5.96%	2.61%
5-Year Gov't Bonds:	7.33%	6.58%
20-Year Gov't Bonds:	7.08%	11.44%

Source: Ibbotson Associates

Source: TIM

You will notice that Intermediate bonds, defined as those with a maturity of five years, had higher total returns with almost half the risk (standard deviation) of long-term bonds.

MIDLAND'S PROCESS TO MANAGING MUNICIPAL BONDS

We believe laddering provides a municipal AAA bond portfolio with staggered maturities so that a portion of the portfolio will mature each year. Laddering tends to outperform other bond strategies because it simultaneously accomplishes two goals:

1. Captures price appreciation as the bonds age and their remaining life shortens.
2. Reinvests principal from maturing short-term bonds (low yields) into new Intermediate bonds (higher yields).

However we also review certain issues that are special to the municipal bond itself. We feel those issues can be captured in the table below. As we build a municipal bond portfolio for you, our process weeds out the bonds which are window dressed by investment bankers to look good but peeling off the cover reveals a bad stench.

RISK CONTROL STRATEGIES	
Risk	Solution
Credit Risk	Careful selection, diversification, ongoing credit review
Income Tax Risk	Municipals and tax-deferred
Market Price Risk Reinvestment Risk	Compromise

Source: TIM

We believe since the Federal Reserve, Hedge Funds and other soothsayers on Wall Street cannot predict where interest rates are going in the short, intermediate or long-term we will not either. What is point of paying someone to guess? Our focus is to build a portfolio of municipal bonds which provide stable income to you and your family and to provide the bedrock for your overall investment portfolio.

Below is an example of a highly rated municipal bond fund (Franklin Bond Municipal Mutual Fund). You can observe the drastic changes in its price over the last 6 years (May 1995 to November 2003). The aim of a laddered municipal bond portfolio would be to smooth out the changes in value and to create a stream of interest payments to match your income needs. Mutual funds or money managers don't have the time or ability to match your needs specifically. At Midland Asset it is our focus for your income needs to be matched with your income goals.

