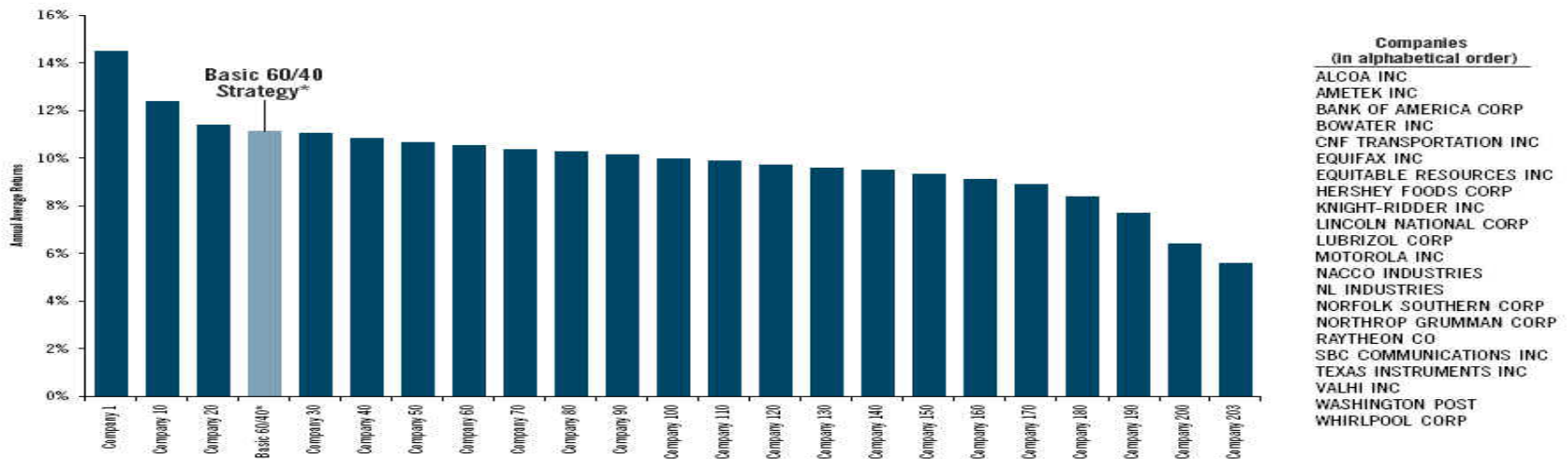


Our first goal is to allocate the stock portfolios to pure asset classes such as large value, small value, international etc without using active managers. Our second goal is to reduce unnecessary costs such as taxes, management fees, and transaction costs. Based on academic and real world analysis only 12.5% of managers can consistently outperform their benchmark over 7 year cycles based on skill and only 1% of those managers can outperform over 21 year cycles based on skill (results can be doubled for the luck factor). Since our clients overall portfolios have time horizons ranging from 3 to 35 years we use active/passive managers to provide consistent capital market returns for each type of asset class both here in America and abroad.

As the study below shows, even American's largest corporations and their pension committees with access to the best and the brightest still on average can't outperform over the long-term against index funds:

Results of 201 Corporate Pension Funds

Basic 60/40 Balanced Strategy vs. Company Plans
Annual data: 1987-2003



*Basic 60/40 is 60% S&P 500 Index, 40% Lehman Intermediate Government/Credit Bond Index, rebalanced monthly.
 Source: FutureMetrics (July 2004); all companies with fiscal year ending December, with complete return data from 1987-2003.

Detail

There are a few terms defined below which might be helpful during our discussion:

Asset Class – Stocks grouped together based exhibiting similar behaviour which can be measured in a number of ways such as **Book to Market** ratio, Market Capitalization, Price Earning ratio etc.

Book to Market – The value of the underlying assets in a company divided by its stock value.

Market Capitalization – The stock value of the company calculated by multiplying the stock price times the number of shares outstanding.

Price Earnings Ratio – The most common measure of how expensive a stock is. Equal to a stock's capitalization divided by its after-tax earnings over a 12-month period, usually the trailing period but occasionally the current or forward period.

Active/Passive Manager - A money manager/mutual fund who owns all the stocks available in an asset class, believes stock selection or market timing does not produce consistent performance and has fees similar to an index fund.

When we begin to advise clients on creating or reviewing their investment portfolio, our first question and concern is the income they need regardless of what the stock market or the economy does. We also worry about protecting that income against a September 11th event. The answer(s) creates the percentage allocated to bonds. The next question is the various timeline(s) the investments might have. For example, clients could have money in retirement, taxable and trust accounts each with their own timeline, tax plans and purposes. The goal during these discussions is to determine the different mixes of stock asset classes.

Owning stocks is risky because you do not know what the value of those stocks will be over the next 1, 3, 7, 15, 25 years etc. We assume if our clients have to take this type of risk to keep pace with inflation or to achieve various wealth migration strategies there should be a finite amount of risk assumed. For example, we view risk like a bucket of water in the desert – use it carefully and only when you have to. If clients have a career or a company where they have some advantage we advise our clients to allocate most of their risk to that endeavor. If you have to take risk do it when you have an advantage.

What happens when you have either retired, sold your business or just don't have an advantage to make more money than would with bonds?

The answer comes from academic and real world research which analyzed how to explain where returns come from. Returns come from 3 factors¹:

- 1) Stocks have a higher expected return than bonds.
- 2) Small company stocks have a higher expected return than large company stocks.
- 3) Lower-priced “value” stocks have a higher expected return than higher-priced “growth” stocks.

Once you know where stock returns come from, and you know that stocks are riskier than bonds, there are only two items still to decide during the creation or review of an investment portfolio. The first item is the allocation of stocks to bonds. The second item is the allocation of stock asset classes to meet your risk and return criteria.

Midland uses active/passive managers who own all the stocks available in an asset class. These managers define an asset class based on the Book-to-Market of all the stocks in that asset class and own the bottom third to quarter. The value-added for our clients is a pure exposure to that asset class risk and return. For example, if a client allocated 50% to the Large Value asset class the performance would equal the expected risk and return numbers of large value companies over the long-term. When clients use an active manager, nobody knows what the exact amount of risk and return might be because of manager turnover, portfolio shifting, portfolio window-dressing, Wall Street shenanigans etc. Using an active manager is like letting a bull find the most efficient path through a china shop – nothing but one big mess. Midland’s approach finds the most efficient path for our client’s money balancing stock risk and stock return.

We know our approach does not have “hope” attached to the process. That is for the gamblers. We believe in the efficiency and belief in our capital markets and look to add value in providing and controlling the pure exposure to risks and returns while reducing unnecessary costs.

¹ Explains 96% of the returns from a diversified stock portfolio. See Fama and French.