

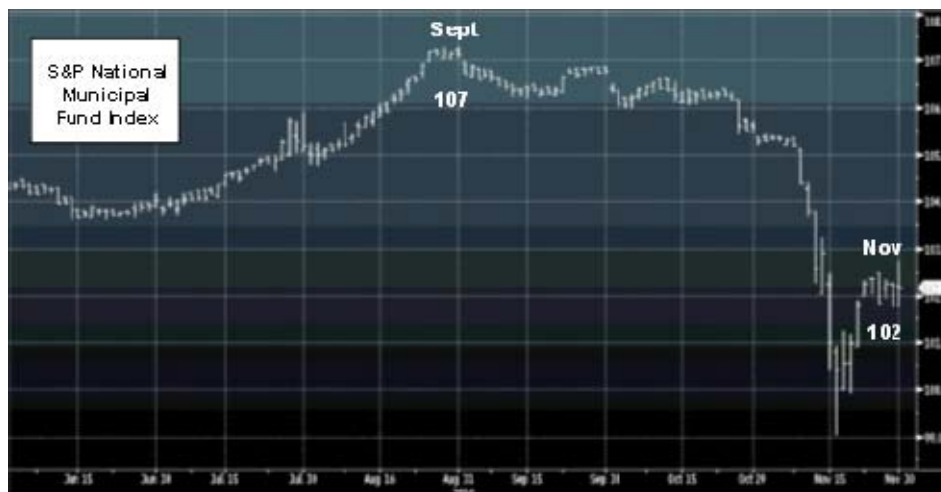


November 30, 2010

Caution... Blind Curves Ahead

For the week ending November 17 investors pulled a record amount of dollars out of municipal bond funds. The withdrawal was estimated at \$4.8 billion dollars and was more than the \$4.2 billion outflow in October 2008 at the height of the financial crisis. According to Lipper FMI, a Thomson Reuters Consulting unit, it was the largest weekly outflow since the firm began tracking the data in 1992. This reversal followed 19 consecutive weeks of inflows into long term U.S. municipal mutual funds averaging \$535 million per week. Since 2008, \$670 billion has gone into long maturity bond funds. This is in comparison to a trailing ten year net annual inflow average of approximately \$42 billion. This rate of flow into long bond funds is over 3 standard deviations from the norm.

The reason for this November reversal of bond fund purchases can be attributed to a number of market factors in addition to the simple fact the market has exploded in size the last 2 years. These factors include the Feds disappointing second round of quantitative easing; QE2, the threat of the Build America Bonds (BABs) program ending and the Republicans taking control of the House in mid-term elections. According to the FED, QE2 was intended to keep interest rates low and the result has been completely the opposite. Since the anticipation of QE2 in September, the yield of the long U.S. Treasury bond has gone from 3.4% to 4.3%. The volatility of the long maturity municipal market can be seen in the 6 month S&P National Municipal Fund Index price chart below. The index, which has approximately a 9 year average maturity, has declined in price 3.4% in November.



Another familiar name in the bond world; PIMCO Municipal Income III, experienced even more volatility. It is down 6.1% for the month of November and at one point was down 9.5%. This recent downside price volatility has been primarily driven by a rush of redemptions rather than a sudden change of fundamentals. Municipal fundamentals have been under pressure for over 2 years and are reasonably transparent. The selling pressure in November was due to investors responding to *future* expectations of municipal budget stress, increased bond supply, higher interest rates and inflation. The market weakness was experienced across all bond maturities but was more intense in longer durations.

Investors need to heed these recent market actions and be very cautious moving forward. Long maturity portfolios are subject to significant price volatility. When fundamentals actually do begin to change and rates start to cycle higher history tells us increases can occur quickly. In 1994 the Fed raised the discount rate 9 times from 3% to 6% in a 12 month period. The 30 U.S. Treasury Bond yield went from 6.2% to 8% and the bond price declined 19%. At the bottom of the last rate cycle in 2004 the Federal Reserve raised the Fed Funds rate 17 times in 24 months. Fed rate increases are driven by the health of the economy and is how the Fed fights inflation. The timing and velocity of this next cycle will be driven by the current economic recovery and obviously influenced by the high current rate of unemployment. The current economic recovery is moving slower than in past recessions which will delay the rate increase cycle. However, the amount of liquidity that the Fed has pumped into the markets is at historical high levels which will increase pressure for higher rates. The timing of higher rates is open to debate but when markets are at all time historical low levels the direction of the next move seems quite obvious.

How do investors position their bond portfolios for the uncertain markets in front of us? MPI Investment Management strongly recommends that investors review their portfolios and focus on analyzing average maturity and credit quality. Proper security selection in a rising interest rate environment is critical. The longer average maturity that your portfolio has the more risk you are taking. Mistakes can result in severe long term damage to an investor's portfolio. Owning longer maturities will not allow a portfolio to increase its yield without taking losses in those positions. In this cycle it is critical to also understand the size of the bond mutual fund marketplace is several times the norm. When rates rise it will send some investors to the sell window in an effort to shorten up maturities. This could cause liquidity and volatility issues in the current overbought mutual fund bond market.

Individually managed accounts are more flexible than mutual funds and ETFs and are not subject to liquidity selling pressures experienced by retail bond funds. Short average maturity, high quality bond portfolios, will be resilient to rates moving higher and allow the portfolio to walk up its yield with rising rates. The time to make portfolio adjustments is NOW. MPI managed bond portfolios have average maturities of less than 5 years and are very high quality. This MPI short high quality structure is very well suited in a rising rate environment. It has proved successful for MPI fixed income clients for 25 years.

This MPI white paper is the forth such published in 2010 cautioning investors the consequences of higher interest rates. The other articles can be found on MPI's website: www.mpi-invest.com

March 18, 2010 *Is Your Bond Portfolio Ready for Higher Rates*
September 13, 2010 *A Sign of Things to Come*
October 18, 2010 *Wall Street Transcript Interview*

The October Wall Street Transcript interview was highlighted on Yahoo Finance Oct 25, 2010. Interview link: <http://finance.yahoo.com/news/Is-Inflation-Just-Around-The-twst-1351226122.html?x=0&.v=1&.pf=retirement&mod=pf-retirement>



David W. Pequet, 58, founded the advisory firm MPI Investment Management, Inc. in 1986. MPI manages over 250 million dollars of primarily fixed income institutional and high net worth portfolios in the United States and in Europe. During the last two decades MPI has been nationally recognized several times for its fixed income investment management. Prior to starting MPI Mr. Pequet specialized in fixed income at several Wall Street securities firms including Prudential-Bache and Mosley Securities. He earned an Engineering degree from Michigan State University in 1974. Following college Mr. Pequet was in the Naval Aviation Officer Flight Program. For the last 25 years Mr. Pequet has been active at the executive level in several community and youth programs in the Hinsdale Illinois area, including 8 years as a board member of the Oak Brook Plan Commission, 6 years as coach and Director of the Hinsdale Little League, and has been a Director and Treasurer of the Hinsdale Public Library Foundation for the last 7 years. Mr. Pequet has been active for 25 years with the Roger B. Chaffee Scholarship Fund in Grand Rapids Michigan as both a Director and Treasurer. David is a member of The Bond Club of Chicago. In recent years he has been quoted and interviewed by Chicago Crain's Business Magazine, Investment News and The Wall Street Transcript. Mr. Pequet has been married to Christine since 1976 and they have two son's both in the investment business.

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