

MPI

INVESTMENT MANAGEMENT, INC.

What a difference a year makes!

March 24, 2008

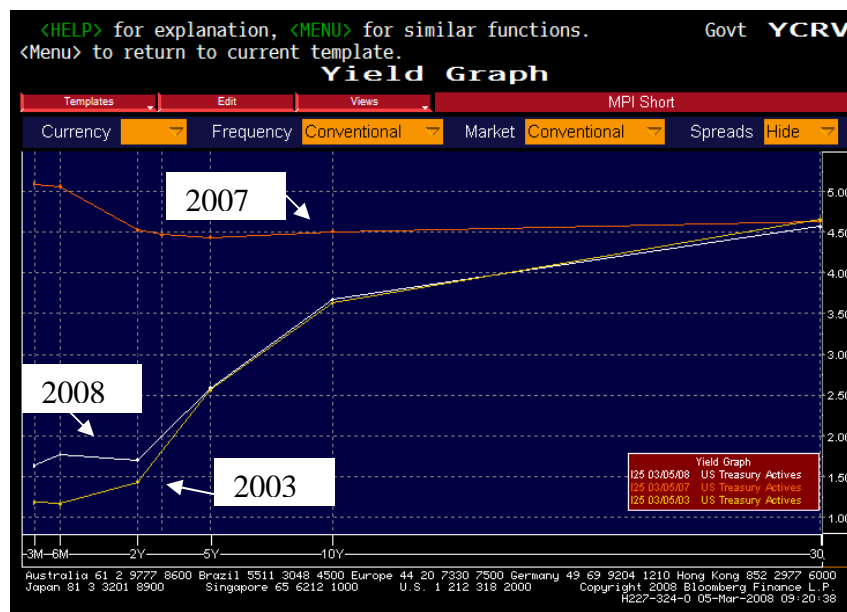
Twelve months ago bond investors were looking at an inverted yield curve with short rates significantly higher than long. Money market yields were hovering around 5% and 30 day commercial paper and auction rate securities' yields were north of 5 ¼%. It can also be noted that Bear Stearns was trading over \$150 per share and the stock market was breaking upside records almost daily.

Today the 2 year US Treasury Note is yielding 1.45%, commercial and corporate paper is fraught with credit risk, money markets are filled with subprime CDO's and SIV's, Bear Stearns is trading at \$10/shr. and the auction rate market is frozen in time, leaving investors questioning what the definition of "cash equivalents" truly is.

In early 2007, we were cautioning investors to resist the temptation of rich yields offered by money market funds and short term corporate and commercial paper and to begin gradually extending their maturities to capture 5% yields in high quality government bonds before short term rates collapsed.

In our 20+ years of bond investing experience an inverted yield curve suggests troubling times ahead. And in contradiction to popular belief at the time it wasn't "**different this time.**" As you well know by now the Fed has lowered rates by an astonishing 300 basis points since August of 2007 (when their bias was actually "risk of inflation") bringing the fed funds rate to 2.25% after today's move. This action coupled with their action two weeks ago to accept mortgage backed securities of any quality as collateral for access to high quality Treasuries has temporarily steadied the credit markets.

Now as we look forward, past the present day fog of the housing malaise, credit market illiquidity and investor unease, we see a familiar picture; the yield curve. We need not look back too far in history to see a steep yield curve buoyed by multiple Fed rate cuts, a Bush tax stimulus package and widespread investor unease. In fact we need only look back a few short years to early 2003 to see these familiar market patterns and reactions. Yes, the drivers of that slowdown were different than today's, led by an internet stock bubble, and terrorist attacks, but the yield curve and the monetary and fiscal response were nearly identical. See the yield curve comparison in the chart below:



As objective professional bond managers, it is our job to remove emotion and invest according to market fundamentals and historical patterns. Looking ahead 18-24 months we see similar changes taking place in the present day yield curve as we saw coming out of 2001-02. The current low rate environment along with the simplest medicine of all, the passage of time, will help heal our housing economy and unfreeze the credit markets. This will lead to investors beginning to gradually dip their toes back into the pool of riskier asset classes in the search for returns in excess of inflation. Inevitably, the Fed will be faced with the “risk of inflation” returning and begin raising rates, shifting the yield curve upward and eventually back into a moderate and then ultimately flat shape once again. And the cycle repeats.

In light of this we remind our existing and potential new clients to once again resist temptation. This time in the form of chasing yields and locking in longer term maturities at these present levels, as in the next 12-18 months both short term and long term rates will be significantly higher than they are today. The ideal strategy for this environment is a short to intermediate maturity focus with maturities ranging from 12 months to 5 years in duration depending on your own personal objectives. This approach has proven successful in capturing competitive yields while at the same time allowing enough cash flow and liquidity for investors to “walk up” the yield curve. As we illustrated in the above yield curve chart a disciplined investor in 2003 could have walked up the yield curve and in a few short years had the ability to capture rates 100 basis points above a 10 yr. bond purchased in 2003, and with only a 2 year maturity to boot.

Two things we must all learn from this difficult time are a.) No matter what the so called pundit experts tell us it is never “different this time” and b.) Interest rates can move swiftly and sharply in a short period of time making both cash equivalents and long term bonds relatively risky investments.

This reaffirms our long held philosophy that a high quality, short to intermediate maturity, actively managed bond portfolio is an important and prudent addition to every investor’s overall investment portfolio.

-Bradley C. Smith

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