

Central Plains Advisors, Inc.

The Bond Market – A License to Steal?

In our opinion there has been since the beginning of time major structural problems with the functioning of the worlds largest financial market, the US domestic bond market. It has very successfully brought debtor and creditor together but by custom and practice has always favored the broker dealer at the expense of the investor. The winds of change, however, are at hand. We believe our management style, which has always benefited the investor by eliminating most of the middlemen, will be the major beneficiary of this irreversible secular change.

The bond market has long been a salesman's paradise. The lack of transparency has allowed huge mark-ups, anywhere from 1% to 5% both on the buy and sell side of the transaction. This, many times, does not even include the dealers mark-up. It is estimated that broker commissions and bond bankers fees amount to \$25 billion per year.

Most all corporate and municipal issues have call features. In effect this allows the issuer to "steal" your capital gains and saddle you with any loses that might develop due to changes in interest rates. Heads they win, tails you lose. To add insult to injury the investor not only loses his capital gains if interest rates decline but is forced to incur another huge mark-up to replace his called bonds.

Another impediment to the investor has been the long secular bear market in bonds, which terminated in 1981. This spawned many myths of which two we consider particularly onerous. (1) Interest rates cannot be projected by anyone and (2) long dated bonds are too risky based upon their historical returns as compared to intermediate bonds. As concerns the projection of interest rates, the culmination of the long secular bear market in bonds again, which ended in 1981, proved to bankers and money managers alike that they had no idea how the economy works. Rather than admit their failing they covered it up and convinced the investing public that if they couldn't project rates no one could. While at Bank IV in Wichita (Bank of America) we in the banks trust accounts sold all bonds with maturities in excess of three years. Although for policy reasons the commercial bank sold no bonds, in our investment portfolios no new purchases were made over the same period

of time, 1977 through 1980. As the shorter paper matured, the money was allowed to accumulate for later purchase starting in 1981. Millions of dollars were saved and made. We have successfully projected rates since 1974. Not perfectly, but 80% of the time if measured quarterly. On the other matter since 1981 long term bonds have out performed intermediate bonds. In effect most sold out at the markets low, so much for projections that extrapolate prior trends into the future. Even a first year college student in finance knows a 30-year bear market in bonds will allow intermediate bonds to perform better over such a period. Both of these axioms are untrue and once again have benefited the broker and broker dealer at the expense of the investor. Laddered and/or shorter maturities create more portfolio turnover and broker mark-ups.

Yet another condition which has unnecessarily benefited the industry at the expense of the investor is the distribution mechanism, particularly as it pertains to mutual funds. As Art Laffer told us some 10 years ago “your record is the best I’ve ever seen but performance is not nearly as important as distribution and marketing.” Big names, high fees, large commissions, glossy brochures and lack luster performance seem to go hand in hand. Please compare any bond mutual fund with our record. You will be amazed.

The Wind they call Internet

The Internet has come to the bond market. Please note the enclosed article Bonds play game of catch up. We are much encouraged by this development. As the article mentions the aging population will be turning more and more to bonds in their retirement years. This increased demand plus a more transparent market is good for all concerned in general and Central Plains Advisors, Inc. in particular. Bond investors, there is coming a better day and we have a better way.