Alban Investment Management, LLC Newsletter for March 2003

This monthly newsletter provides information for anyone interested in investments.

The newsletter has three sections. ***Investment and Economic Indicators*** gives a brief snapshot of some current and predicted conditions. ***Investment Product of the Month*** provides information on a selected investment product or opportunity. The topic this month is **high yield bonds**. The topic next month will be **inflation protected Treasury bonds**. ***Investment Topic of the Month*** provides information on an investment concept. The topic this month is **investment expense efficiency**. The topic next month will be on the **tax efficiency of retirement savings accounts**. If this newsletter was forwarded to you and you wish to receive future issues, please e-mail me at **rcalban@alban-invest.com** so that I can add your e-mail address to the distribution list. Or, if you want to be dropped from the e-mail list, please e-mail at the same address.

My firm provides two major services: (1) the development of comprehensive, long-term investment plans to achieve client objectives, and (2) the on-going management of investment assets. My goal is to help clients achieve their investment objectives through a combination of sound investment principles and practical knowledge. To learn more, visit **www.alban-invest.com**, or e-mail me at **rcalban@alban-invest.com**.

All contents are informational only, and are not legal or tax advice. Nothing contained herein is an offer to buy or sell any security.

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Investment and Economic Indicators

Category	Total Return YTD as of 2/28/03	Comments
1. High Yield Corporate Bonds	+4.2 %	Default rates continue to decrease.
2. Investment Grade Bonds	+1.6 %	Lower interest rates, higher bond prices.
3. Municipal Bonds	+1.0 %	
5. Money Market Funds	+0.1 %	
6. US Equities Overall	-4.4 %	Equities hurt by geopolitical risks.
Technology	-1.1 %	Best performing sector.
Telecommunications	-14.9 %	Worst performing sector.
7. Dev. World Equities Overall	-6.6 %	
Canada	+5.1 %	Best performing developed country.
Norway	-15.5 %	Worst performing developed country.

Region	Current Unemployment Rate	Comments
7. United States	5.7 %	
8. Euro Area	8.5 %	Rigid labor markets, vast social welfare.
9. Japan	5.5 %	

Other US Data	Status	Comments
10. 10 yr. T-Bond interest rate	dropped .2% points in Feb. to 3.8%	Fed may lower rates one more time.
11. Projected 2003 inflation rate	2.2 %	
12. Exchange Rates on 2/28/03		

Euro to $	1.0765	$ remained even with the Euro in Feb.
Lb. Sterling to $	1.6472	$ strengthened by 4.5% in February.
Yen to $	0.008341	$ weakened by 1.5% in February.

Note: The weaker dollar will help US exporters and hurt those importing into the US. The dollar weakened by 15% in 2002 on a trade weighted basis.

13. Global Cell Phone Projected Unit Volume (for 2003)	430 million units	China is now the largest single market for cell phone volume.

Economic Boondoggle of the Month

14. The developed nations of the world spend over 500 billion dollars a year to subsidize their farmers. The subsidies are funded by taxes collected mainly from non-farmers. The biggest subsidizer is Europe. These subsidies lead to overproduction and artificially low prices. Farmers in the underdeveloped world, who receive no subsidies, often cannot compete with these subsidized exports. This leads to the virtual collapse of the agricultural sectors of many underdeveloped countries--which causes even deeper poverty. The developed nations then collect additional taxes to provide the underdeveloped world with aid--which only partially offsets the damage done by the agricultural subsidies. To remedy this needless tragedy, the underdeveloped countries are seeking radical reductions in the farm subsidies of developed countries in the current round of WTO trade negotiations. The leading opponent of reducing agricultural subsidies is (you guessed it!): France.

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Investment Product of the Month: High Yield Bonds

High Yield Bonds (originally called junk bonds) first appeared as a major sector of the bond market in the 1980s. High yield bonds are rated below investment grade. For instance, bonds rated BB+ or below by Standard & Poors are considered to be high yield bonds. As their name implies, high yield bonds have high yields because there is substantial risk that the bond will go into default, which means all the interest and principal promised to the bondholder will not be paid. Prior to the 1980s, high yield bonds came into existence because a corporation became financially distressed, and their bonds dropped to below investment grade. High yield bonds created in this way are sometimes referred to as **fallen angels**. In the 1980s, Michael Milken pioneered the **issuance of new high yield bonds** to fund leveraged buyouts and leveraged takeovers. These bonds were rated as high yield as soon as they were issued. Huge sums of money were raised using this technique. Today, over 80% of high yield bonds are issued as high yield, and less than 20% come from fallen angels. High yield bonds are also now used in Europe and other developed countries.

Today, US high yield bonds have an average yield of **11.1%** versus a 10-year Treasury bond yield of **3.7%**. The total return of high yield bonds must be adjusted for default rates and recovery rates. The 30-year weighted average default rate on high yield bonds is about 4.5%. However, there can be wide variations in default rates by year. During the 1990/91 recession the default rate rose well above 10%. And in 2001, the default rate was just under 10%. After a bond is in default, the bond holders may still recover some value. The average historic recovery rate is about 40% of the face value. However, during the telecom meltdown of 2002/02, recovery rates plummeted to about 20%.

Historically, after adjusting for default rates and recovery rates, **high yield bonds have averaged about 2 percentage points of total return above that of Treasury bonds.** This is consistent with the principle that investors will be rewarded with higher average returns for accepting higher risk.

Generally, high yield bonds tend to do **poorly** even before a recession starts because higher default rates are a leading indicator of economic troubles. But, high yield bonds tend to do **better** as a recession nears its end, because default rates often start to drop before economic recovery is apparent.

It is usually best to buy high yield bonds using a **mutual fund** because this provides diversification as a way of reducing risk. Holding individual high yield bonds is best left to professional traders.

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Investment Topic of the Month: Unnecessary Investment Expenses

Unnecessary investment expenses are expenses that do not (1) increase returns, (2) reduce risk, or (3) save the investor time. Unnecessary expenses can act as a major drag on the performance of a portfolio over the long-term.

A strong case can be made that the extra expenses associated with **actively managed mutual funds** are unnecessary (if equivalent exchange traded funds or index mutual funds are available). According to recent Securities and Exchange Commission statistics, actively managed mutual funds have **average annual expenses ratios of about 1.35%**. This means 1.35% of the value of the assets in the fund are deducted to pay fund expenses. However, the published expense ratios do not cover **all** fund expenses. Trading commissions and some securities research are not included in the expense ratio. If included in the expense ratio, these expenses would probably add at least another 0.5%. So, a more accurate average expense ratio is about **1.85%**. Many mutual funds also deduct one-time sales **commissions** (sometimes referred to as loads). This is money deducted (either when shares are purchased or redeemed) to pay commissions to the salesperson that sold you the mutual fund. These can range from **1% to 5%**. To add insult to injury, actively managed mutual funds often generate **extra tax liabilities** for the investor. Mutual funds must distribute net capital gains to the shareholders each year, but cannot distribute net capital losses! Capital gains can be generated by the buying and selling that the fund manager does or by redemptions by other shareholders. Thus, even if you do not sell and shares in an actively managed mutual fund, you may be allocated a substantial capital gains distribution that you must pay federal and state income tax on. If the fund is in a tax-deferred or tax-exempt account, this tax problem is not an issue, but it certainly is a problem in a taxable account.

When all the above factors are combined, the expenses associated with actively managed mutual funds reduce long-term returns by about 3% per year in taxable accounts. A portfolio of 60% stocks and 40% bonds can be expected to have a long-term return of about 8% per year, before expenses and taxes. So, the 3% of expenses reduces investment returns by over a third, unless there are counteracting benefits. Exchange traded funds and index mutual funds will usually have a total expense/tax impact of less than 0.5% per year.

What are the benefits from actively managed mutual funds? Many objective and comprehensive studies have examined whether there is evidence that actively managed mutual funds do better than market benchmarks or index mutual funds. The consensus of these studies (particularly the ones done with the most care) is that there is **no** evidence that supports that actively managed mutual funds outperform the market. In fact, there is considerable evidence that **actively managed mutual funds tend to under perform** the market. Actively managed funds do reduce risk (through diversification) and can save the investor time in creating a diversified portfolio. However, these benefits of diversification and time saving can be obtaining using exchange traded funds or index mutual funds--at a much lower cost.

If an exchange traded fund or index mutual fund does not exist for the segment of the market you want to invest in, then look at actively managed funds. Try to find a fund with no sales commissions, a low expense ratio, and a low portfolio turnover.

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