Alban Investment Management, LLC Newsletter for April 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 **inflation protected Treasury bonds**. The topic next month will be **real estate investment trusts (REITs)**. ***Investment Topic of the Month*** provides information on an investment concept. The topic this month is **tax efficiency of retirement savings accounts**. The topic next month will be on **value investing**.

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**.

Ron Alban
Principal
937-294-0988

- -

Investment and Economic Indicators

Category	Total Return YTD as of 3/31/03	Comments
1. High Yield Corporate Bonds	+6.9 %	Default rates continue to decrease.
2. Investment Grade Bonds	+1.5 %	Rates unchanged since 1/1/03.
3. Municipal Bonds	+1.0 %	Growing concern about quality.
5. Money Market Funds	+0.2 %	
6. US Equities Overall	-3.5 %	Equities hurt by geopolitical risks.
Internet Services	+22.4 %	Best performing sector.
Tobacco	-25.1 %	Worst performing sector.
7. Dev. World Equities Overall	-8.8 %	Most European markets down sharply.
Austria	+4.7 %	Best performing developed country.
Netherlands	-16.0 %	Worst performing developed country.

Region	GDP Forecasted Growth for 2003	Comments
7. United States	2.5 %	
8. Euro Area	1.1 %	Rigid labor markets, vast social welfare.
9. Japan	0.5 %	Deflation, banks have excessive bad loans.
10. Entire World	2.2 %	Slow growth with downside risk.

Other US Data	Status	Comments
11. 10 yr. T-Bond interest rate	unchanged at 3.8%	Fed may lower rates one more time.
12. Commodity Prices	+8.2% over past year	Indicates some reduction in overcapacity.

13. % Change in Exchange Rates since 1/1/03

Euro to $	+3.9%	Euro continued to strengthen.
Lb. Sterling to $	-1.8%	Pound weakened slightly.
Yen to $	+0.1%	Japanese government wants weak yen.

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.

14. GDP of Russia as a% of US GDP	4%	That's right, the size of the entire Russian economy is about 4% of the US economy.

SARS: Health Risk and Economic Risk

15. The new respiratory illness known by the acronym SARS appears to have originated in southern China, near Hong Kong. The disease appears to be highly infectious and has had a mortality rate of about 4%. The greatest number of cases has occurred in China and Vietnam. Because of the ease of international travel, the disease has quickly spread to other parts of the world, including a serious outbreak in Toronto. The World Health Organization, in conjunction with national health organizations, is launching a massive effort to limit the spread and discover a treatment. In the meantime, it appears the disease is beginning to cause economic disruption in Southeast Asia, which is a major center of manufacturing, particularly for chips and other high tech gear. There have already been plant closings, conference cancellations, etc. due to concerns about the illness. Thus, it is possible the projected GDP growth in Southeast Asia for 2003 may be reduced by as much as 1 percentage point due to this illness. It could also cause disruptions to US manufacturers who have fabrication facilities in Southeast Asia.

- -

Investment Product of the Month: Inflation Protected Treasury Bonds

Treasury Inflation-Protected Securities (TIPS) are special bonds issued by the US Government.
Background: TIPS were first issued in 1997. Other countries such as the UK and Canada issued similar type of bonds a number of years before the US. TIPS represent about **3%** of outstanding US Treasury bonds--and thus have a bit thinner trading environment than conventional US bonds.
Provisions: The interest rate is fixed. However, the principal amount is adjusted for inflation every six months. For instance, if inflation (as measured by the CPI) increased 2% over a six-month period, the the principal amount would increase from $1000 to $1020. Interest payments are made semi-annually based on the **inflation adjusted principal**. At maturity, the securities are redeemed at the **greater** of the inflation-adjusted principal or the par amount at original issue. So, both the interest payments and the principal amount are protected from inflation (but not from taxes, as discussed later).
Economist's Perspective: TIPS provide a measure of the true, risk-free (as risk-free as you can get on this earth), **real** interest rate. The current yield on a 10-year TIPS is presently at 1.96%. The yield on a conventional 10-year Treasury bond is presently at 3.81%. Unlike conventional bonds, TIPS provide no incentive for the government to create inflation.
Investor's Perspective: TIPS offer a way to **hedge** the risk of inflation--and still hold a fixed income security. Traditionally, investors looked mainly to equities or real estate as a way to deal with inflation risk. TIPS offer another tool. Of course, the **cost** of acquiring this hedge is a lower interest rate and yield. TIPS also can be valuable for portfolio **diversification and efficiency**. This is because the returns of TIPS have exhibited (at least so far) low correlations with stocks and conventional bonds. Because real interest rates are less volatile than nominal interest rates, the price of TIPS is also **less volatile** than conventional bonds. Of course, the IRS had to throw in a negative. Both the interest payments and the **principal adjustments** are taxable in the current year--even though you do not receive the principal adjustments until the security reaches maturity. I have not analyzed the impact of this--but it could be quite significant in a high inflation environment--and it diminishes the effectiveness of the hedge.
Final Thoughts: The prices of all Treasury securities have been driven up due to both low interest rates and a flight to safety. As interest rates rise and geopolitical uncertainties are reduced, the price of Treasury securities may drop quite significantly. Thus, one should be very cautious before buying TIPS right now. Several TIPS mutual funds have been established--and I continue to prefer this means of ownership versus owning individual bonds.

- -

Investment Topic of the Month: Tax Efficiency of Retirement Savings Accounts

Having studied this issue in great depth, I have discovered a simple truth: **No simple truth on this topic exists** (despite the frequent appearance of such claims in the popular media). However, it is a very important issue. Properly managing and optimizing the long-term, after-tax returns of retirement accounts can make a **big** difference in how long these investments will last after you retire. There are four commonly available types of retirement accounts: **tax-deferred** (such as Traditional IRAs & 401(k)s), **tax-free** (Roth IRA), **variable annuities**, and ordinary **taxable** accounts. I discuss some of the considerations below.

Point 1. The analysis must be done over the **long-term** to capture all of the tax impacts. This is because there is a time value to money. For instance, if you contribute to a tax-deferred account now, you save taxes now, but create a future tax liability. What is the present value of this approach versus one of the other approaches, such as a Roth IRA? This can only be done by a long-term, after-tax cash flow analysis.

Point 2. The analysis must include looking at the **sequence and mixture** of how **savings** should be allocated between types of retirement accounts before retirement--as well as the sequence and mixture that **withdrawals** should be made after retirement. The sequence and mix of savings and withdrawals will make a big difference in long-term after tax returns.

Point 3. The analysis must include looking at all income taxes: **federal, state and local**. You'd be surprised the impact that state and local income taxes can have. In addition, the analysis must go beyond just the application of tax bracket rates. You must look at capital gain rates versus ordinary tax rates, deductions, and how your tax rates might change after retirement.

Point 4. **Tax-deferred accounts require very thorough analysis**. Because contributions are pre-tax, you reduce your tax liability for the year the contribution is made. A key question is: what do you do with the money you saved on taxes? If you use the money for incremental consumption, there is no savings or investment benefit. If you do save the money, what do you put it in--a taxable account or a tax-free account? These choices will largely determine the relative attractiveness of making contributions to tax-deferred accounts versus other choices.

There are more items that need to be included in the analysis, but I will summarize a few general guidelines that often result from a comprehensive analysis. However, these guidelines may not apply to **your** specific situation and should not be followed without doing an analysis.

First, the **optimal** pre-retirement **savings** plan usually is a **mix** of tax-deferred, tax-free and taxable savings. This mix will depend on your individual tax situation and employment situation.

Second, the **optimal** post-retirement **withdrawal** plan is usually taxable funds first, tax-deferred funds second, and tax-free funds third.

Third, it is usually best to pay the taxes due on withdrawals from tax-deferred accounts from **taxable** accounts. This usually increases long-term, after-tax returns on your portfolio taken as a whole.

There will be more on this topic in future newsletters--including the pros and cons of variable annuities.

- -