Alban Investment Management, LLC Newsletter for February 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 **exchange traded funds**. The topic next month will be **high yield bonds**. ***Investment Topic of the Month*** provides information on an investment concept. The topic this month is **efficient portfolios**. The topic next month will be **investment expense efficiency**.

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.

Ron Alban
Principal
937-294-0988

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Investment and Economic Indicators

Category	Total Return for Jan. 2003	Comments
1. High Yield Corporate Bonds	+2.9 %	Default rate is expected to decrease.
2. Investment Grade Bonds	+0.1 %	
3. Money Market Funds	+0.05 %	Money market rate is below inflation rate.
4. Municipal Bonds	-0.5 %	
5. US Equities Overall	-2.5 %	Equities are affected by geopolitical risks.
Healthcare	-0.4 %	Best performing sector.
Telecommunications	-7.1 %	Worst performing sector.
6. Dev. World Equities Overall	-4.1 %	
New Zealand	+4.8 %	Best performing developed country.
Finland	-9.3 %	Worst performing developed country.

Region	Projected GDP Growth for 2003	Comments
7. United States	+2.5 %	Assumes gradual recovery.
8. Euro Area	+1.3 %	Structural problems are limiting growth.
9. Japan	+0.4 %	Structural problems are limiting growth.

Other US Data	Status	Comments
10. 10 yr. T-Bond interest rate	unchanged in Jan.	Fed may lower rates one more time.

11. Projected 2003 inflation rate 2.2 %

12. Exchange Rates on 1/31/03

Euro to $	1.0765	$ weakened another 2.5% in January.
Lb. Sterling to $	1.6472	$ weakened another 2.3% in January.
Yen to $	0.008341	$ strengthened 1.1% in January.

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. Broadband internet penetration in US	20 million households by end of 03	Roughly 2/3 by cable modem, 1/3 by DSL.

Strangest Situation of the Month

14. Japan is suffering from persistent deflation. The overall price index has declined for 39 consecutive months. It has gotten so bad that some creditors are paying debtors to borrow money (a negative interest rate). Consumers hesitate to spend because they wait to get a better deal from future lower prices--which decreases demand--which causes prices to fall further! It's a nasty cycle--and the Japanese government doesn't know what to do. It's one reason the Japanese economy is doing so poorly.

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Investment Product of the Month: Exchange Traded Funds

Exchange Traded Funds (ETFs) were first introduced in the mid-to-late 1990's. ETFs are baskets of stocks that closely track the composition and performance of many leading indices. ETFs are not actively managed, and thus are much like index mutual funds. But unlike mutual funds, ETFs trade like stocks: they can be bought and sold through any brokerage account throughout the trading day. There are over 60 billion dollars invested in ETFs--and this amount is growing rapidly.

ETFs are very attractive investment vehicles to achieve diversification at a very low cost.

Superior tax efficiency. ETFs have minimal capital gains distributions--and are more tax efficient than mutual funds. Unlike mutual funds, ETFs are not vulnerable to capital gain distributions caused by redemptions of other shareholders.

Low expenses. The expense ratio for an ETF is usually much less than equivalent mutual funds, including index mutual funds. The expense ratio is often one-half less. There are no sales commissions or redemption fees.

Excellent flexibility. ETFs trade just like stocks. They can be bought on margin, sold short, and some even have options.

Excellent modularity. ETFs are available for narrowly focused segments. For instance, you can purchase ETFs for Long Duration Treasury Bonds, an Italian Stock Market Index, or a US Real Estate Index. Index mutual funds may not exist for all of these types of narrow segments.

Knowledge of holdings. Unlike mutual funds, you can always know the holdings of an ETF in real time by going to a web site to view all the holdings.

iShares are the leading brand of ETFs. Barclays Global Investors creates and administers iShares. There are over 80 iShares funds to choose from. Extensive information about iShares is available at **www.ishares.com**.

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Investment Topic of the Month: Efficient Portfolios

To view a PowerPoint presentation on this topic, go to **www.alban-invest.com** and select **Investment Topics** from the left-hand menu. You do not need PowerPoint software to view the presentation.

The concept of efficient portfolios was first proposed in the 1950's, and has been researched extensively by leading investment and finance scholars. **Efficient portfolio theory is one of the pillars of modern investment management.**

First, some definitions. Future investment returns are uncertain. This fact can be modeled by estimating an expected return and an expected volatility (uncertainty) of this return. **Volatility** is defined as the expected standard deviation of the return. The greater the standard deviation, the greater the volatility and risk. **Asset classes** are groups of securities that have similar return/volatility characteristics, as discovered through analysis of long-term historical securities' data. Long-term Government Bonds and Small Value Stocks are examples of asset classes. A **portfolio** is a mixture of asset classes.

Asset class returns do not move in unison. For instance, changes in returns from a money market asset have a very low correlation to changes in the returns of stocks. Correlations between movements of asset class returns are estimated through the analysis of long-term historical securities' data. The **volatility of a portfolio** depends on **both** the volatility of its asset classes and the correlations between the asset classes. Due to the lack of perfect correlation between asset classes, the volatility of a portfolio will almost always be **less** than the average volatility of its constituent asset classes.

An **efficient portfolio** is one that has the highest expected return for a given level of expected of volatility (risk). Another way to think about it: if you could choose between two portfolios of equal expected volatility, but one has a higher expected return than the other, which one would you prefer? **The goal is make your portfolio efficient** by finding the optimum mixture of asset classes to give you the level of expected risk you desire--while maximizing the expected return at that level of risk. Doing so can make a big difference in the success of your investment plan over the long-term.

Efficient portfolios, at any specified level of return or volatility, can be derived using mathematical techniques for optimization. A key **assumption** is that the **future correlation** between asset class returns will be similar to **long-term historical correlations** (going as far back as the 1920's in some cases). There is no guarantee that this assumption will hold true--but how likely is it that the fundamental long-term relationships between stocks, bonds, and money markets will drastically change in the future? Not likely, in my judgment.

Defining the asset class mix for an Efficient Portfolio serves as a guideline to follow--to be augmented with judgment. **It should never be used be used as a rigid or mindless formula**.

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