Alban Investment Management, LLC Newsletter for June 2003

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 **municipal bonds**. **Investment Topic of the Month** provides information on an investment concept. The topic this month is **interest rates & bond prices**. Past issues of the newsletter can be found at **www.alban-invest.com**.

July's newsletter will focus entirely on the investment implications of the recently enacted federal income tax law changes.

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 list, please e-mail me at the same address.

My firm provides two 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 5/30/2003**	**Comments**
1. High Yield Bonds	**+14.1%**	low defaults, high demand
2. US Equities Overall	**+10.5%**	strong recovery in April/May
Technology	+19.6%	best performing sector
Telecommunications	-2.3%	worst performing sector
3. Developed World Equities	**+5.4%**	very strong in May
Canada	+19.74%	best performing
Japan	-2.73%	worst performing
4. Investment Grade Bonds	**+4.5%**	
5. Municipal Bonds	**+4.2%**	unusually high rate relative to Treasuries
6. Money Markets	**+0.4%**	below inflation rate

Country	**Unemployment rate**	**Comments**
7. United States	6.0%	very gradual decrease expected
8. Japan	5.4%	needed reforms will increase rate in short-term
9. Germany	10.7%	major economic reforms required
10. Great Britain	5.1%	
11. France	9.3%	major economic reforms required

Average Hours of Work Per Year

<u>Per Full Time Worker</u>

12. South Korea	2477 hours	and you thought you worked long hours!
13. United States	1821 hours	
14. Western Europe	1400 hours	lots of vacation, holidays, strikes, & mysterious sick days

15. % change in exchange rates since 1/1/03

Euro to $	+12.1%	euro continues to strengthen
Lb. Sterling to $	+1.6%	
Yen to $	-0.5%	Japanese gov. intervenes to try to keep yen weak

Note: The strong euro is favorable to US exports going into Europe.

Economic Reform in Germany

Germany is the first major country to fall victim to **Alban's Law** (revealed now for the first time): **About 100 years after a country starts a comprehensive social welfare system, the system falls apart due to inherent contradictions in its structure.** Germany was the first country to introduce a comprehensive social welfare system in the late 19'th century--and now it is falling apart.

The social welfare system in Germany includes: 34 weeks of unemployment benefits, "free" government run universal health care, 6-7 weeks of legally mandated vacation per year, numerous holidays, extensive sick leave/maternity leave, extensive subsidies, extreme difficulty for companies to lay off workers, a highly regulated labor market, "free" higher education (for those admitted), and a lot more. It took about a 100 years, but the situation now is: the highest labor costs in the world (50% higher than even the US), chronically high unemployment, very high taxes, low levels of entrepreneurship and business investment, low consumer demand, very low birth rates, massive unfunded social welfare liabilities, and general economic stagnation. The economic situation has been made worse by the strengthening of the euro against the dollar--which has made German exports less competitive.

There is cause for optimism, however. The German government seems determined to implement major reforms despite much screaming and gnashing of teeth, such as reducing unemployment benefits from 34 months to 12 months, relaxing restrictions on the labor market, etc. It will be painful, but it is possible enough reforms will be made to slowly turn Germany around.

Incidentally, we started our social welfare system in the 1930's. Projections show that Social Security and Medicare will become insolvent in the time frame of 2020-2040--about a 100 years after the beginning. The sooner we make reforms, the less the pain will be.

<u>Investment Product of the Month: Municipal Bonds</u>

Municipal bonds are debt obligations issued by levels of government other than the federal government. This includes states, counties, cities, townships, school districts, and a whole host of state and local government agencies. There are about **85,000** government entities that issue municipal bonds! It is a large market. There's about **1.8 trillion dollars** worth of municipal bonds outstanding today in the United States.

The interest from municipal bonds is **exempt** from federal income tax and from the state income tax for the state of issuance. For instance, if an Ohio resident owns a municipal bond issued within the state of Ohio, the Ohio resident pays no Ohio income tax on the interest payment. If an Indiana resident owns an Ohio municipal bond, the Indiana resident will pay Indiana income tax on the interest. Bonds issued by Puerto Rico are tax exempt in all states. Because of the tax exempt status, municipal bonds usually carry interest rates **lower** than other types of bonds.

Municipal bonds come in **many flavors**. **General obligation** bonds are the lowest risk types because they are backed by the full faith of the issuing authority. **Revenue** bonds are issued to fund specific projects and are repaid by the revenue generated by the project. If the revenue falls short of expectations, the bonds can go into default. The point is: **there are many kinds of municipal bonds and they are definitely not all risk free**. If an investor wishes to buy individual municipal bonds, diligence is required to understand the credit risk. Munis often have call provisions which effectively cap total investment returns.

Investors in **high** federal tax brackets (usually above 25%) and also in **high** tax states have the **highest demand** for municipal bonds because they have the most to gain from the tax free interest payments. Thus, historically, the price of municipal bonds (and the yield) has been largely determined by the purchase bids placed by high tax bracket investors. The yields tend to be driven down to the level that makes economic sense for high tax bracket investors. In fact, the yields are usually driven down to the point that municipal bonds **rarely** make economic sense for investors in the **lower** tax brackets. Lower tax bracket investors can earn higher after-tax returns by investing in taxable bonds that have higher interest rates. Also, it **never** makes sense to hold municipal bonds in tax advantaged accounts such as IRAs because holdings in these accounts are already tax-exempt.

The yields on municipal bonds relative to US Treasury bonds are presently very **high** by historical standards. Some 10 year municipal bonds are yielding almost as much as 10 year Treasury bonds--which seems to defy economic rationality since munis are tax exempt and Treasuries are not. The reason is that the credit quality of many munis has **declined** in recent years as many state and local governments are facing fiscal distress (California especially). Investors are demanding a **higher** yield as compensation for a higher risk of default. As the fiscal distress is solved, expect muni yields to drop to a more normal level.

If munis are appropriate for your portfolio, buy a low cost municipal bond **mutual fund** (which diversifies your risk), unless you are prepared to research individual issues. A mutual fund also avoids the high transaction costs of buying and selling municipal bonds that the individual investor will usually pay.

Investment Topic of the Month: Interest Rates & Bond Prices

A number of factors cause bond prices to change. **Changes in the prevailing interest rates** and changes in the credit quality of the issuer are two of the primary factors. It is very important to understand the relationship between interest rates and bond prices--particularly in the current environment of very low interest rates. To illustrate this relationship, I will use US Government Treasury Bonds (**T-Bonds**) as an example. This is because the credit quality of US Treasury Bonds is extremely high and is not expected to change. Thus, **changes in the price of T-Bonds are mainly due to changes in interest rates**, rather than due to changes in credit quality.

Interest rates are the **price to borrow money**--and are determined by the demand for money by borrowers and the supply of money from creditors. Many factors influence the level of interest rates including the level of economic activity, expected inflation, and the money supply policies of the Federal Reserve. There are many different interest rates in the economy: on mortgages, consumer loans, corporate bonds, etc. One widely used benchmark to track the general prevailing rate of interest rates in the economy are the yields on T-Bonds. As of May 30, 2003 the yields were as follows:

For a T-Bond maturing in **2** years: **1.3%**
For a T-Bond maturing in **10** years: **3.4%**
For a T-Bond maturing in **30** years: **4.3%** (estimated rate, new 30 year T-Bonds are no longer issued)

These are the **lowest** Treasury yields in **40** or more years. **When interest rates rise, prices of previously issued bonds will fall until all T-Bonds of equal duration have the same yield.** However, the prices of **long duration** T-Bonds will **fall much further** than those for T-Bonds with a short duration. This due the **time value of money**--but an explanation of the mathematics associated with the time value of money is beyond the scope of this essay. Consider the results in the table below.

Amount of Interest Rate Increase from Today's Level	**% Price Decrease for T-Bonds with Maturities of: 2 Years**	**10 Years**	**30 Years**
+1%	-2%	-8%	-15%
+2%	-4%	-15%	-26%
+3%	-6%	-22%	-36%

As you can see, rather **modest increases in interest rates can cause a large decrease** in the price of long maturity bonds. If one holds the bond until maturity--the price will eventually return to the face value of the bond. But how many people buy a bond with the expectation of holding it for 20 or 30 years?

Current T-Bond yields are 1.5% to 2.0% **below** their long term historic averages. It is likely that interest rates will **rise**-- although no one can predict the timetable for this to occur. The moral of the story: be **cautious** about holding long maturity bonds in the current low interest rate environment. When interest rates rise, the prices of these bonds will fall sharply.
