Alban Investment Management, LLC Newsletter for May 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 **REITs.** The topic next month will be **municipal bonds**. Investment Topic of the Month provides information on an investment concept. The topic this month is **value investing**. The topic next month next month will be **interest rates & bond prices**. Past issues of the newsletter can be found at **www.alban-invest.com**.

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**.

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Investment and Economic Indicators

Category	Total Return YTD 2003	Comments
1. High Yield Bonds	+12.9%	low defaults, high demand
2. US Equities	+4.8%	strong recovery in April
Technology	+9.1%	best performing sector
Telecommunications	-7.6%	worst performing sector
3. Investment Grade Bonds	+2.4%	
4. Municipal Bonds	+1.9%	
5. Money Markets	+0.3%	
6. Developed World Equities	-0.3%	
Ireland	+13.95	best performing
Japan	-7.1%	worst performing

Region	Trade Balance, $bn (last 12 months)	Comments
7. United States	-504	reason dollar is weakening
8. Canada	+35	
9. Euro area	+96	
10. Japan	+96	

Other Data	Status	Comments
11. 10 year T-bond rate	up .1% to 3.93%	near historic lows
12. 2003 US inflation rate	2.3%	stable

13. 2003 US wage rate	3.1%	good productivity growth

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

Euro to $	+6.5%	euro continues to strengthen
Lb. Sterling to $	-0.6%	
Yen to $	-0.1%	

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

15. Emerging world country with largest foreign debt: Brazil, with a total of $220bn. Brazil's debt service equals 81% of its exports (which is the source of hard currency to pay off the debt). Hint: be wary of investing in Brazil.

A Tale of Two Countries

Consider South Korea and North Korea, which were split into two countries 50 years ago. One is a free market democracy--the other is a centrally planned dictatorship. Here's a comparison.

	North Korea	South Korea
1. GDP	$19bn	$420bn
2. GDP per capita	$909	$9050
3. Population	21 mil.	46 mil.
4. Military expenditures as % of GDP	25%	3%
5. Armed forces as % of population	5.2%	1.4%
6. International trade as % of GDP	13%	62%

Any questions about the fruits of freedom?

Investment Product of the Month: Real Estate Investment Trusts (REITs)

REITs are specialized companies that invest in **commercial real estate**--and must conform to certain legal requirements. These include: (1) A REIT must distribute at least **90%** of its net income as dividends each year. In return, REITs are **exempted** from paying corporate income taxes. (2) A REIT must have **75%** of its assets in real estate and must derive at least 75% of its income from rents and fees derived from real estate. (3) The portfolio of real estate must be **diversified**, and no more than 30% of income may come from selling properties held for less than four years. This is to prevent excessive speculation. (4) The majority of the board of directors must be **independent**. REITs have nothing to do with real estate limited partnerships and the fiasco that occurred with limited partnerships in the 1980s.

REITs have been around for about **40** years. They are regulated by the SEC and other federal and state agencies. During the 60's and 70's, some shenanigans occurred that gave REITs a bad name. However, the industry has matured and has been quite solid over the past 15 years. For instance, very few (if any) REITs were involved in the wave of corporate scandals of the late 1990's.

REITs own about **10%** of the commercial real estate in the US--and their share will probably gradually grow. Their shares are publicly traded. The market capitalization of REITS is over $125 billion. A particular REIT usually specializes in a segment of the real estate market such as apartments, shopping centers, office space, etc.

What are the characteristics of REITs as an asset class? Average annual pre-tax return over the past 20 years was about **10%**. REIT prices are **less** sensitive to changes in interest rates than most fixed income securities. REIT prices have historically been **less** volatile than most other classes of stocks. REIT price movements have a relatively **low** correlation with other equities. For instance, during the stock market collapse of 2000-2002, REIT prices held up quite well.

What are advantages of owning REITs as part of a portfolio? First, REITS can be expected to **reduce** the overall volatility of your portfolio due to their low correlation to other equity asset classes. Second, REITs provide an **ownership interest** in real estate, with the benefits of diversification and liquidity. Third, REITs provide a **high** dividend rate with the upside potential of price appreciation.

Unless you follow the various real estate sectors very closely, you are well advised to buy a **REIT mutual fund**, rather than individual REITs. REITs benefited from a flight to safety during 2000-2002, which caused their prices to rise. It may **not** be the optimum time to buy REITs right now.

Investment Topic of the Month: Value Investing

What is value investing? Value investing is referred to as a style of investing in stocks. Value stocks are stocks that have **low price-to-earnings ratios** and **low price-to-book value ratios** (compared to the average of all stocks). Note: the book value is the value of a company's equity as reported on it's published balance sheet. There is no universally agreed upon definition of a value stock. Usually, the most weight is given to a low price-to-book value. Imagine calculating the price-to-book value ratio for all the publicly traded stocks in the United States--and then ranking them from high to low. Take the companies in the lowest one-third--and define these as value stocks. This is as good a definition as any. (Note: companies in the highest one-third are known as growth companies).

What information does the low price-to-earnings or low price-to-book ratio convey about a value company? Essentially, the market is conveying that it has **low expectations** for the future prospects for a value company. This can include expectations of a low revenue growth rate, poor margins, legal liabilities, threats from competing technologies, etc. Frequently, though certainty not always, a value company has had something **go wrong** within the past five years--like a scandal, major product failure, etc.

How have value stocks performed as an asset class? Many studies have been done on comparing the performance of value stocks versus growth stocks. The results given below are based on a rigorous study by Ibbotson. These results are similar to most other credible studies that have been done.

1968-2002

	Compound Average Annual Return	Standard Deviation of Annual Return
Small-cap growth stocks	3.2%	24.1%
Large-cap growth stocks	10.4%	23.6%
Large-cap value stocks	12.8%	19.3%
Small-cap value stocks	13.1%	22.6%

Over the past 34 years, **value stocks as an asset class have performed considerably better than growth stocks**--and with less volatility. Similar results have been confirmed as far back as 1926. I stress these results are at the asset class level, because an individual value stock may perform very poorly (like going bankrupt), and an individual growth stock may perform superbly.

What explains the above average of value stocks as an asset class? Well, that is open to debate. The most widely accepted view is this. **Because the market has low expectations for value companies, they are often able to exceed these low expectations over time.** Remember the management and employees of a company should be trying to improve the performance of a company--they are working to exceed the low expectations. If the low expectations are exceeded, the stock price moves up. On the other hand, the market has high expectations for a growth company. Sometimes, these expectations are unrealistic (remember the late 1990s!) and are not achieved--in which case the stock price moves down. When aggregated over thousands of companies and many years, these tendencies create the differences in the asset class performance.

An efficient portfolio will usually contain **both** value stocks and growth stocks. However, it is usually wise to have a **greater** weighting of value stocks compared to growth stocks.
