Alban Investment Management, LLC Newsletter for November 2003

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. **Investment Topic of the Month** provides information on an investment concept. Past issues of the newsletter can be found at **www.alban-invest.com**.

The **Investment Product** for November is **US Savings Bonds**. The **Investment Topic** for November is **Efficient Market Theory**.

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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Ron Alban
Principal
937-294-0988

Investment and Economic Indicators

Category	Total Return YTD 10/30/2003	Comments
1. **Developed World Equities**	**+25.1%**	strong markets, weak dollar
Sweden	+42.4%	best performing country
Netherlands	+10.9%	worst performing country
2. **US Equities Overall**	**+24.1%**	
Technology	+45.7%	best performing sector
Telecommunications	-3.4%	worst performing sector
3. **High Yield Bonds**	**+22.7%**	default rates remain low
4. **Municipal Bonds**	**+3.7%**	
5. **Investment Grade Bonds**	**+3.1%**	
6. **Money Markets**	**+0.9%**	below inflation rate

Tidbits:

7. Mutual fund fees collected each year: **130 billion dollars. For what investor benefit?**
8. Projected US GDP growth for 2004: **+3.9 %.**
9. Projected Euro area GDP growth for 2004: **+1.8%.**
10. Projected Japan GDP growth for 2004: **+1.8%.**
11. Decline in IPO activity: **in 1999 there were 486 IPO's, in 2003 YTD there have been 40.**
12. Literacy rate of women in Afghanistan: **2%. That's not good.**

% change in exchange rates since 1/1/03

13.	Euro to $	+10.3%
14.	Lb. Sterling to $	+5.3%
15.	Yen to $	+8.0%

The dollar continues to weaken against other major currencies. This will help US exporters.

US Savings Bonds

US Savings Bonds can in certain circumstances be a useful investment vehicle.
The **general** circumstances that make Savings Bonds attractive are:

1. You want **low risk and do not need high returns**.
2. You do **not need to convert the investment into cash for at least 5 years**.

Additional **special** circumstances that make Savings Bonds attractive are:
3. You live in a **high tax state**.
4. You expect your federal tax rate to **drop** in the future.
5. You will be cashing the Savings Bonds to use for **higher education** expenses.

You should not purchase Savings Bonds without **understanding** the all the detailed terms and conditions, which can be found at **www.publicdebt.treas.gov/sav/sav.htm**.

Some of the key information and considerations are discussed below.

Savings Bonds are **not marketable securities**. You buy them from the US government. When you want to cash them in, the US Government redeems them. The only parties are you and the US government.

There are two types of Savings Bonds you can purchase: **I Bonds** and **EE Bonds**. I Bonds are issued with a **fixed** rate that is adjusted every 6 months for **inflation**. The current fixed rate is **1.1%**. EE Bonds are issued with a variable rate that is adjusted every 6 months to be equal to 90% of the average interest rate paid on 5 year Treasury Bonds. The current rate is **2.61%**. You can hold the bonds for as long as 30 years. The interest accrues, rather than being paid out to you. Under current regulations, you can purchase up to $30,000 per year of each series of bonds.

There are **significant restrictions on when you can redeem** Savings Bonds. First, you are **prohibited** from redeeming them for the first year after purchase. Second, if you redeem a bond before 5 years, three months of interest are **deducted**. This is why if you need the cash within 5 years, Savings Bonds are probably not the right choice.

The **advantages** of Savings Bonds are:

1. You pay **no commissions** to purchase or redeem them, and there are **no ongoing expenses that are deducted**.
2. You pay **no state income tax** on the interest.
3. You can elect to pay federal income tax on the accumulated accrued interest in the year that you redeem the bond. If you can redeem the bond in a year that you have a **lower** federal tax rate, this will **reduce** you long-term tax liability.
4. If you redeem the bond and use the proceeds for **higher education** expenses, the interest is **exempt** from federal income tax.
5. Unlike tradable bonds, including Treasury Bonds, the **value of a Savings Bond does not change as prevailing interest rates in the economy change.** This is because the US Government guarantees to redeem a Savings Bond at the value you paid for it plus accrued interest--even if the prevailing interest rates have increased. With a tradable bond, as interest rates rise, the price you can sell the bond for decreases. With a Savings Bond, you can benefit from higher interest payments if rates rise, without the disadvantage of falling value. This can be a significant advantage during periods of rising interest rates.

Savings Bonds can be purchased on-line or through participating financial institutions. The government has indicated that it intends to move toward on-line purchases only, as early as next year.

Efficient Market Theory

Efficient Market Theory is about **security pricing**. One way to express this theory is: **It is impossible to make abnormal profits (other than by chance) in a securities' market by using publicly available information to**

formulate buying and selling decisions. The underlying assumption of this theory is that there are enough **informed and rational participants** in the market to keep the market price of each security equal to its **"true" investment value**, which is the present value of the security's future prospects as estimated by a capable analyst. Poorly informed or irrational investors will create "noise", but this noise is self-canceling because the irrational optimists will be canceled out by the irrational pessimists.

Predictions of Efficient Market Theory include:

1. Any impressive performance by a particular investor is due to chance and will disappear over time.
2. Publicly known investment strategies will not result in abnormal returns.
3. Professional investors will fare no better than ordinary investors.
4. Past performance is not an indicator of future performance.
5. Paradoxically, markets will be efficient only if enough investors believe they are not efficient.

If you believe in this theory, you will be a passive investor. You will invest in a diversified asset mix of index funds. You will not spend time doing research or picking individual securities because you believe there is no way to obtain abnormal gains, except by chance. My own corollary is: **if you (or someone on your behalf) does not do any research and analysis on investments, you should be a passive investor because the informed and capable investors will likely make money at your expense.**

My own belief based on reviewing a lot of research and my own experience: US securities markets (**in aggregate**) are reasonably efficient over the long-term (5 years and longer), but are significantly inefficient at the **individual security level** in the short term (less than 5 years).

The **distinction** between aggregate market price behavior and individual security price behavior is important to understand. It is quite possible to have some securities **irrationally overpriced** and other securities **irrationally under priced**--but the aggregate market will appear to be **fairly priced** because the overpriced and under priced securities will "cancel out" the irrationality when viewed in aggregate.

There are several points to bolster the notion that individual securities can exhibit significant price inefficiency in the short-term.

1. **Even using the same information about a security, different investors will reach different conclusions about its "true" investment value**. Football scouts, using identical information about a prospect, often reach very different judgments about the value of a prospect. It is quite natural that equally informed investors will reach different conclusions about the future prospects for a security. Thus, the price of a security does not equal the "true value" (whatever that mystical value is), but the minimum value of investors who continue to hold the security in light of other investment alternatives.
2. **The ability of rational investors to drive prices to a rational value is limited in the short term**. For instance, if an investor believes a security is overpriced, the main way to profit from this is to sell the stock short. However, there are practical limits to the amount and duration of short selling. These limits often make short selling insufficient to move the price back to a rational level. A classic example of this occurred during the stock market bubble of 1998-2000. Since virtually the whole market was irrationally overpriced, short sellers would have required hundreds of billions (maybe even trillions) of dollars to drive the prices down. Such resources were not available.
3. **Many securities are followed by very few analysts or investors--and so the market price is based on very few informed investors.** This leads to inefficiencies. For instance, I have observed small, profitable, growing companies with no debt that have stock prices below their balance sheet cash holdings. This is hard to reconcile with efficient market theory.

I want to emphasize the other point: **markets are reasonably efficient (in aggregate) over the long term**. Rationality does eventually win out. So, the longer the time frame, the harder it is for any investor to maintain a high level of abnormal returns. Those few who do (such as Warren Buffet) tend to become billionaires

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