Alban Investment Management, LLC Newsletter for October 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** and **Investment Topic** for October are combined to focus on the **unfolding mutual fund scandal** and **exchange traded funds (ETFs).**

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 9/30/2003	Comments
1. **High Yield Bonds**	**+20.2%**	default rates remain relatively low
2. **Developed World Equities**	**+17.7%**	strong Japan market, weak dollar
Denmark	+32.4%	best performing country
Finland	+2.7%	worst performing country
3. **US Equities Overall**	**+17.0%**	
Technology	+33.0%	best performing sector
Telecommunications	-7.9%	worst performing sector
4. **Investment Grade Bonds**	**+4.1%**	
5. **Municipal Bonds**	**+4.0%**	
6. **Money Markets**	**+0.8%**	below inflation rate

Tidbits:

7. Global steel-making capacity utilization: **85% (due to excess capacity).**
8. Global steel-making capacity utilization needed for industry stabilization: **probably above 93%.**
9. Each country's proposed solution to steel industry problems: **I'll keep my steel mills operating, you shut down yours.**
10. Result of current global gridlock over steel-making: **chronic instability in global steel industry, losses for many integrated steel mills, frequent government intervention involving subsidies, quotas, and tariffs.**
11. Private property in China: **It is likely that China will soon add legal recognition and protection for private property to its constitution--further reinforcing its movement away from a centrally planned, government owned economy towards a market based economy.**

% change in exchange rates since 1/1/03

12.	Euro to $	+11.1%
13.	Lb. Sterling to $	+3.4%
14.	Yen to $	+6.5%

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

More About the Mutual Fund Scandal and Exchange Traded Funds (ETFs)

The unfolding scandal in the mutual fund industry highlights the type of **abuses** that can occur (if safeguards are circumvented) with mutual funds to the detriment of honest investors. In many situations, Exchange Traded Funds are a better alternative than a mutual fund. There are also many situations in which mutual funds remain a sound investment choice.

There are over 6000 mutual funds in the United States--and it is likely that most of these funds were not involved in the scandal--and some of them may have been unknowing victims. However, with new press reports appearing almost daily, it seems that **abuses and/or illegalities occurred on a large scale** and probably involved hundreds of millions of dollars of ill-gotten gains over the past several years. These ill-gotten gains were spread over a very large base of mutual fund investors--and so the loss to an individual mutual fund investor was probably small. But small losses aggregated over millions of investors adds up to a lot of profits for those who abused the system.

Below, I explain the nature of the abuses.

Definitions

The key word in mutual funds is "**mutual**". When you own a share of a mutual fund, you own a fractional share of the total value of all the assets in the fund. You do not own an undivided interest in the individual assets in the fund. The value per share is **calculated** by the mutual fund company and is called the **net asset value (NAV)**. The NAV is calculated **once** each business day **after the close** of business. Buy and sell orders entered **before** 4:00 PM Eastern time are required to be processed at the NAV calculated for that same day. Orders entered **after** 4:00 PM are required to be processed at the NAV calculated after the close of the **next** business day.

Mutual fund shares are **not traded**. There is no "mutual fund market" like a stock market. There are no bid/ask offers as in a stock market auction system. When you buy shares in a mutual fund, you buy the shares from the mutual fund company--not from another investor. When you sell shares in a mutual fund, the mutual fund company exchanges your shares for cash.

Exchange Traded Funds (ETFs) were introduced in the mid-1990's. ETFs are baskets of stocks or bonds that closely track the composition and performance of many leading indices. ETFs are **not** mutual in nature. When you own an ETF, you obtain an undivided **ownership** in the individual holdings within the fund. ETFs are **not** actively managed, and thus are like index mutual funds in that respect. But unlike mutual funds, ETFs **trade** like stocks: they can be bought and sold throughout the trading day. The price of an ETF share is **not** a calculated value, it is determined through the **bid/ask auction system** of buyers and sellers in the stock market. When you buy an ETF, you are buying it from another **investor**. When you sell an ETF, you are selling it to another **investor**. There are over 100 billion dollars invested in ETFs in the US--and this amount is growing.

The Abuse

Profits can often be made from **inefficiencies** in a market--and mutual funds exhibit quite a few inefficiencies because they are not bought or sold using a market system!

Take the situation at the close of day this past Friday, October 3. The US stock market closed up by 1.04% as measured by the Wilshire Total Value Index. Due to time zone differences, most other developed world stock markets close well **before** the US stock market closes. There is an ETF that trades on the US stock market (trading symbol EFA) that represents the Morgan Stanley index for most non-US developed country stock markets. It closed Friday up 1.46% at **$122.41 per share**. However, if you calculate a value for this ETF based on the last closing prices of the international stocks in it, you arrive at a value of **$120.18**. At first, it may seem odd that the ETF price is **higher** (by 2.23%) than the last closing prices of the constituent international stocks. But it is not odd if you understand that there is a **high correlation** (around 80%) between the movements of the international stock markets and the US stock market. Since the US stock market did well on Friday, the price of the ETF was bid up in the **expectation** that when the international stock markets open on Monday (well before the US stock market opens), international stocks will rise in price (on a dollar denominated basis) by slightly above 2%. There is no guarantee this will happen, but there is a good probability it will happen.

Now, suppose there is a mutual fund with similar international stock holdings as the ETF referenced above. The NAV calculated Friday night will **not** reflect the expectation that international stock markets will rise on Monday because the NAV will be calculated using the last closing prices of the international securities--which are based on **outdated** information. So, **if** you could **buy** shares at Friday's NAV and then sell the shares at **Monday's** NAV, you have the chance to make a 2% profit in one day. However, this profit represents a reduction in the total value of the mutual fund--and thus is value taken from the remaining mutual fund shareholders.

The tactics used to accomplish this are referred to as **market timing** or **late trading** of mutual funds.

Late trading means that an order entered **after** 4:00 PM is executed at the current day's NAV rather than at the next day's NAV. This gives the trader **additional** time to obtain information that helps predict the likely price movement of the mutual fund for the following day, while still being able to buy shares at **today's** value. Late trading is **illegal**. To accomplish late trading requires the complicity of someone at the mutual fund company or at a broker or other order taker. Allegations of late trading have surfaced and one indictment has been issued.

Market timing means the ability to buy and sell mutual fund shares in a very **short** trading cycle--such as to buy shares one day and sell them the next. This is not per se illegal. However, most mutual funds try to **prevent** it because of its negative effect on long-term holders of the mutual fund shares. Many mutual fund companies state in fund prospectuses that they will adopt policies to discourage market timers. This can be done by imposing short-term redemption fees or by canceling any account which shows evidence of rapid trading. If a mutual fund which claimed to discourage market timers, knowingly permitted market timers to trade, then the fund company may be liable for civil damages. Allegations have surfaced that some mutual fund companies and some brokers allowed market timing to take place in conflict with their publicly stated policies.

The Solution

1. The SEC needs to vigorously **enforce** regulations against late trading.
2. Investors need to seek **damages** against offending mutual funds via class action law suits.
3. The mutual fund industry needs to **reform** itself so as to minimize market trading.
4. Investors need to **shun** mutual funds that do not have strong market timing safeguards in place.
5. Invest in **ETFs**, whenever practical, instead of mutual funds. Because ETFs are traded and give the investor undivided ownership, ETFs are not affected by late trading/market timing strategies. There are other advantages to ETFs versus mutual funds. To learn more about ETFs, see the February 2003 newsletter at **www.alban-invest.com**.