Alban Investment Management, LLC Newsletter for September 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 September** is **an introduction to put options**. The **Investment Topic for September** is **regression to the mean.**

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 8/31/2003	Comments
1. **US Equities Overall**	**+18.3%**	recovery continued in August
Technology	+34.3%	best performing sector
Telecommunications	-3.9%	worst performing sector
2. **High Yield Bonds**	**+17.0%**	prices recovered in August
3. **Developed World Equities**	**+14.2%**	recovery continued in August
Sweden	+30.0%	best performing country
UK	+6.4%	worst performing country
4. **Investment Grade Bonds**	**+1.2%**	prices recovered a bit in August
5. **Municipal Bonds**	**+1.0%**	prices recovered a bit in August
6. **Money Markets**	**+0.7%**	below inflation rate

Tidbits:

7. Total net worth of US households: **over 41 trillion dollars**
8. Largest foreign holder of US government debt: **Japan** ($442 billion dollars)
9. Projected inflation around the world: **between 1-3% for all developed economies**
10. Russian military personnel 1992: **2.2 million**
11. Russian military personnel 2002: **0.7 million (less than one-third of 1992 level)**

	Projected Real GDP Growth for 2004	
12. United States	4.3%	strong growth expected
13. Euro area	2.6%	modest growth
14. Japan	3.0%	emerging from 15 year "funk"

Observation on the Mutual Fund Industry Scandal

You may have read about the scandal now brewing in the mutual fund industry. Some funds permitted their shares to be purchased or sold after 4:00 PM for that day's net asset value, rather than the next day's net asset value. This **late trading** is illegal. Some funds permitted special customers to buy and sell shares very frequently with very short holding periods. This **market timing** is unethical, and may be in some cases be illegal. Both of these practices allowed special customers (usually hedge funds) to obtain profits at the expense of the ordinary share holder. This is because a mutual fund is a **pool**--and if somebody removes value from the pool, the other shareholders **lose value** (dollar for dollar!).

This situation illustrates another **advantage** of exchange traded funds (**ETF**s). See the February 2003 newsletter on my website for an explanation of ETFs. Because ETFs are **not** pools and **trade** on major stock exchanges, an existing shareowner of an ETF will not suffer a loss from late trading or market timing--even if such abuses occur. There are many other advantages of ETFs over mutual funds.

A Brief Introduction to Put Options

Options can be used as an effective **risk management tool**. The theoretical framework associated with options is quite complex and fills many books. This little essay briefly touches on a few aspects.

A **put option** on a stock gives the owner of the option the **right to sell** a certain number of shares of a particular stock at a predetermined price (the **strike price**) at any time until a predetermined time in the future (the **expiration date**). To create an option contract, there is always a seller of the option (sometimes referred to as the **writer**) and the buyer (**owner**) of the option. The writer of the option is obligated (if so requested by the owner) to **buy** the shares of stock from the owner at the predetermined price at any time before the expiration date. There are also put options on entire stock indexes--so you can hold options on an entire sector of the stock market.

The value of an option at a particular time depends upon (1) the price of the stock, (2) the strike price, (3) time remaining before expiration, (4) prevailing interest rates, and (5) the expected volatility of the stock. **In the case of a put option, if the price of the stock declines, the value of the put option increases.** It's beyond the scope of this essay to delve deeper into the valuation of options.

How can a put option be used to manage risk? Suppose you own a large amount of a highly appreciated stock in a taxable account (i.e., it has a low cost basis). You are concerned about the risk that the price of the stock may drop--but you are reluctant to sell the stock because (1) you will trigger a large taxable capital gain, and (2) you believe the stock is likely (but not certain) to continue to do well. You can buy a long-duration put option (with an expiration several years in the future) with a strike price near the current price of the stock. **If the price of the stock declines, the value of the put option will increase and offset the loss of value in the underlying stock.** Due to the way the option market operates, **you do not need to actually exercise the option and sell your shares to realize the value of the put option.** You can simply sell your put option on the options market to an interested buyer. And if you've held the put option for at least a year, the capital gain realized on selling the option is taxed at the lower long-term rate. If the share price of the stock increases, the put option is worthless and may well expire worthless. However, your maximum loss is the purchase price of the option.

If you think about it, **the put option operates in many ways like insurance**--for example, house insurance. When you purchase house insurance, you pay a premium (purchase cost of a put option) to cover a stipulated value (exercise price) for your house for a stipulated period of time (expiration date). In essence, if your house burns down, you can exercise the right to "sell" the ashes of what was your house to the insurance company for the agreed upon value of the house as defined in your insurance policy. If your house doesn't burn down, you are out the insurance premium. Most of us prefer our house insurance "option" expires worthless--i.e.., our house does not burn down. Likewise, when buying a put option for risk management purposes, we're not disappointed if the option expires worthless because we bought the option primarily to cover a downside risk, not to make money on it!

Options are also widely used by **speculators** in an effort to multiply potential profits. This is not risk management, it's speculation. If a speculator believes the price of a stock will drop, then buying put options on the stock is a way to make a highly leveraged "bet" on such a drop. This is a specialized field for people who like to take on a lot of risk. If that's not you, steer clear of using options for speculation.

Regression to the Mean

Regression to the mean is a general concept applied to many diverse phenomena--especially time series data subject to future uncertainty. The **mean** is simply the long-term historic average value of a certain phenomenon. **Regression** is the tendency of a time series to converge on the historic mean (unless there has been a fundamental change in the nature of the phenomenon). Suppose the phenomenon is the average annual rainfall in Dayton, Ohio--which I believe is about 40 inches. Assume there has not been a fundamental change in the long-term weather patterns affecting Dayton. If Dayton experiences several years of sub-normal rainfall (30 inches per year), then it is probable (not certain!) that there will be future years of rainfall above the normal average of 40 inches per year--so that the long-term mean of 40 inches will be reestablished.

Regression to the mean can be used as powerful investment concept. It is usually applied to **asset classes**, rather than individual securities.

The principle can be stated as follows: **If an asset class has recently had investment returns significantly above or below the historic, long-term average return for that class, it is probable future returns will eventually move towards the historic average. This probability increases the longer the time, and the greater the amount, that the returns have deviated from the historic level.**

Here's a real life example for asset class "X".

Based on 30 years of history, X's average return is **9.6%** per year. Then, suddenly, X did very, very well indeed.

year 31 **+41%**
year 32 **+26%**
year 33 **+36%**
year 34 **+80%**
year 35 **+27%**

Many people became very excited about X and a great amount of money was invested in X--especially in years 34 & 35. Either something very fundamental had changed about X (permanent change in average return to a much higher level) or the future returns of X were likely to be very poor (regression to the mean). Here's what happened:

year 36 **-22%**
year 37 **-20%**
year 38 **-21%**

X is US Large Capitalization Growth Stocks. Years 31-35 are 1995-1999 (the **boom**). Years 36-38 are 2000-2002 (the **bust**). The people who invested a lot of money in this asset class at the tail end of the boom, lost a great deal of money during the bust.

What does this mean to the practical investor? Unless you have reason to be believe that the fundamental return characteristics of an asset class have changed, you generally want to **underweight** asset classes in your portfolio that have done unusually well for a prolonged period, and **overweight** asset classes that have done unusually poorly for a prolonged period. This is the **opposite** of what many people do. They invest money in classes that have done very well recently, and sell out of classes that have done very poorly recently. They wind up **buying high and selling low! It's hard to do well that way.**

Rebalancing of a portfolio is a simple and disciplined way to make use of regression to the mean. Your portfolio should have an asset mix structure that is appropriate for your risk preference. Asset classes that do very well will **grow** as a total percentage of your portfolio--and poorly performing classes will **shrink** as a total percentage. To return the portfolio to your target asset class mix, you must **sell** off some of the over performing asset classes and you must **buy** some of the underperforming asset classes. This is consistent with regression to the mean--and it avoids wild swings in your asset class mix.

Caution: regression to the mean provides insight into the future **tendency** of asset class returns--but not the exact amount or timing. A lot of judgment is still required--and extreme changes in a portfolio's asset class mix are rarely warranted based on regression to the mean considerations alone.