

PRINCIPLES

An Investment Newsletter



APRIL 2004

SRI Success: Tyco Embraces Environmental Reporting

by John Wilson, Director of Socially Responsible Investing

OVER 85% OF VOTING SHAREHOLDERS at Tyco Corporation's March 25, 2004 annual meeting (according to the preliminary vote count) supported a CBIS-sponsored resolution that asked the company to create a global environmental reporting system, and to take steps to mitigate potential liabilities arising from toxic emissions from company facilities. This extraordinary vote total, one of the highest ever for a social resolution, was made possible by another extraordinary development, the decision of Tyco management to recommend that shareholders vote in favor of the resolution. CBIS applauds Tyco's willingness to embrace a higher standard for environmental responsibility, and to engage in a constructive dialogue with shareholders on this issue. We also thank the resolution's co-sponsors — Catholic Healthcare West, Healthcare Without Harm, The Sisters of Mercy, The Sisters of the Sorrowful Mother, the CERES coalition, and the Interfaith Center for Corporate Responsibility (ICCR).

An Inauspicious Beginning

CBIS' engagement with Tyco dates back to 1999, when we sought a dialogue with the company in the hopes of persuading it to phase out the use of polyvinyl chloride (PVC) plastic by its Kendall Healthcare subsidiary in the manufacture of IV bags and feeding tubes. Medical products made with

PVC plastic emit toxins during the manufacturing process and when incinerated during disposal, and they leach toxins during use. Many of Tyco's competitors had phased out PVC in favor of more environmentally friendly plastics, and we were concerned that Tyco's competitive position in these markets would suffer as a result. The company, however, was

“CBIS applauds Tyco's willingness to embrace a higher standard for environmental responsibility.”

unreceptive to our request, and refused to engage us in dialogue. Hoping to add leverage to our efforts, we filed a shareholder resolution in late 2002 that requested the phase-out of PVC use, but the resolution received only 2.7% of the vote at the company's March 2003 annual meeting, too low a total under Securities and Exchange Commission rules to allow us to refile the resolution for this year.

In retrospect, Tyco shareholders had a number of more immediate concerns during 2002 and early 2003. A new management team had taken over leadership of the company in the

summer of 2002, intently focused on mending the scandal-ridden firm's weak balance sheet, and on repairing damage to shareholder confidence wrought by the revelation in 2002 of the fraudulent accounting that underpinned the company's apparently stellar growth during the 1990s. With the survival of the company by no means certain, it was difficult to persuade either management or shareholders to focus attention on what could be seen as a narrow environmental issue.

A Change in Tactics

According to research conducted by the Interfaith Center for Corporate Responsibility (ICCR), the level of toxic emissions from Tyco's facilities is among the highest of any U.S. corporation. The company has also been identified under the U.S. Environmental Protection Agency (EPA) Toxic Release Inventory Program as an emitter of lead, lead-related byproducts and dioxins, all of which have been linked to brain damage, slow growth, hyperactivity and other developmental problems in

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children, as well as cancer, reproductive problems, diabetes and high blood pressure in adults, according to the National Institutes of Health (NIH).

Strengthened by a successful debt refinancing in January 2003, Tyco's financial condition improved dramatically, and as 2003 progressed, Tyco shareholders became far more confident of the firm's long-term survival. We judged that the time was right to try again and rally support for an environmental resolution, but one broader in scope, and with a greater chance of generating support among other Tyco shareholders. We targeted the firm's poor environmental record, and lack of a comprehensive environmental policy or reporting system. Of course, we hoped that Tyco management would respond positively to our initiative as well.

The environmental reporting system that Tyco's management team inherited when they took over in July 2002 is simply a jigsaw puzzle of the systems administered by acquired companies — there is no element of central control that can monitor toxic emissions and environmental responsibility on a company-wide basis. In our view, this lack of control presents significant risks to shareholder value, including the potential for toxic emissions that result in legal liabilities and damage to the company's reputation among customers, investors and the public. Perhaps as importantly, toxic emissions are simply wasteful, and waste is costly. Continual attention to environmental concerns prevents problems and reduces costs.

There is also a growing conviction on the part of investors that good environmental stewards will likely also be good corporate managers. Attention to environmental issues signals a commitment to stakeholders and a concern for the long term, which will also show up in more traditional measures of management performance such as product quality and customer service.

Breakthrough

In late 2003, Tyco agreed to dialogue with us regarding our resolution, and in early 2004 the dialogue produced a breakthrough when the company agreed not only to the basic request embodied in the resolution, but actually expressed their intent to recommend to shareholders that they vote in its favor at the March 2004 annual meeting.

Under the leadership of its new CEO, Ed Breen, Tyco's new management is working hard to transform the company's disparate global subsidiaries (which had been loosely administered as a holding company by previous management) into a centrally and tightly controlled operating

“This agreement represents one important step toward remaking Tyco as a successful, responsible, respected enterprise.”

company. Fortuitously, the creation of a firm-wide environmental management system can be seen as an important component of that effort.

Now for the Hard Part

Tyco's sincere commitment to better environmental stewardship is evident in their invitation to CBIS, and to the resolution's co-filers, to participate in the process of creating a set of global toxic emissions standards. In addition, last year Tyco also created and filled the position of Vice President of Environment, Health and Safety, the first such executive role in the history of the company. However, while Tyco's support of our resolution is encouraging, our long experience with company dialogues shows that

turning public commitments into actual behavioral change is often the hardest part of the SRI engagement process. In our view, Tyco's commitment to environmental responsibility must contain several necessary and actionable elements. We will advocate for all these in upcoming discussions with the company:

- First, Tyco must collaborate with shareholders and with stakeholders who will be impacted by the company's environmental performance. We are committed to partnering with Tyco to ensure that it hears a wide array of informed and experienced voices and points of view.
- Second, the company must set specific and measurable targets for emissions reductions in all areas, and hold management and employees accountable for achieving these goals.
- Third, the company should make environmental principles integral to all business planning, from product design to distribution to disposal.
- Lastly, the company must be accountable to its shareholders and stakeholders. Environmental reports should contain all the information shareholders need to evaluate whether the company is meeting its goals. Reporting standards such as the Global Reporting Initiative are becoming accepted standards for corporate social and environmental reporting.

This agreement represents one important step toward remaking Tyco as a successful, responsible and respected enterprise, and we commend Tyco's new management for taking such a positive first step. Indeed, such a company-wide approach to reducing emissions of toxic chemicals is something that CBIS believes is in the best interest of other large corporations and their shareholders. We look forward to our continued dialogue with Tyco. ■

Navigating Bond Market Risk

by Frank Haines, Chief Investment Officer

Bonds serve a variety of roles in participant portfolios. They provide a stable source of income to meet spending and distribution requirements, they offer a means for portfolio diversification due to their low correlation with equities and lower volatility, and they function as a deflation hedge because bond prices rise as interest rates fall.

All three of these traits are apparent in Table I, which compares the return from the Lehman Aggregate Bond Index with that of the S&P 500 over the past 10 years. Bonds have actually been very competitive with stocks over a time frame that includes the tech/dot.com bubble of the late 1990s, the subsequent bear market, and the 2003 equity market upturn. In fact, as shown in Table II, bonds have benefited for more than 20 years from a secular decline in inflation and interest rates.

Is the Bond Bull Market Over?

The bond market consensus is almost unanimous that the Fed will begin tightening later in 2004, and that large trade and budget deficits combined with rising inflationary pressures will result in a decade or more of rising interest rates. However, predicting the

direction of interest rates is never that simple. Even from today's low levels, interest rates can:

- Rise, either sharply or modestly (the results on bond portfolios are very different), if the economy strengthens.
- Fall, modestly or sharply, if the economy weakens.
- Or, stay essentially the same, varying on an annual basis up or down by 50 to 75 basis points depending on the strength of the economy and the markets' response to changes in the many factors that drive interest rates.

Probability certainly seems to favor interest rate increases, on short rates anyway. The Federal Reserve has nearly exhausted its monetary flexibility, dropping the Fed Funds rate from 6% to 1% over the past 3 years. Once the Fed is reassured that employment is growing (part of its dual mandate along with controlling the monetary base, under Humphrey-Hawkins guidelines), it is likely that the Fed Funds rate will rise in one or more steps. However, while rising rates will help the weak U.S. dollar, the Fed has to be very careful due to

the tremendous overhang of debt in the U.S. — both consumer and corporate debt. Much of this debt is now adjustable rate, and while manageable at low rates, the situation will change dramatically should rates rise 2% or 3%. (For example, consumer and corporate debt averaged about 125% of GDP over the post WWII period through the late 1970's, but has surged since 1985 to a current 300% of GDP).

Today, the yield curve is historically steep, as shown in Table III. The difference between cash and long bond yields is now close to 4%; it has averaged closer to 90 basis points over the very long-term, and 200 basis points over more recent time periods. Credit spreads on investment grade corporates, and mortgage-backed bonds, are relatively tight, offering little compensation for individual company risk. As shown in Table IV, the situation today is very different than it was in late 2002 when credit spreads were very wide. Spread tightening was the driver of strong corporate bond returns during 2003, and also produced strong returns on high yield and emerging market debt.

Given a slow upward drift in interest rates over the next several

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Table I. Annualized Returns through March 31, 2004

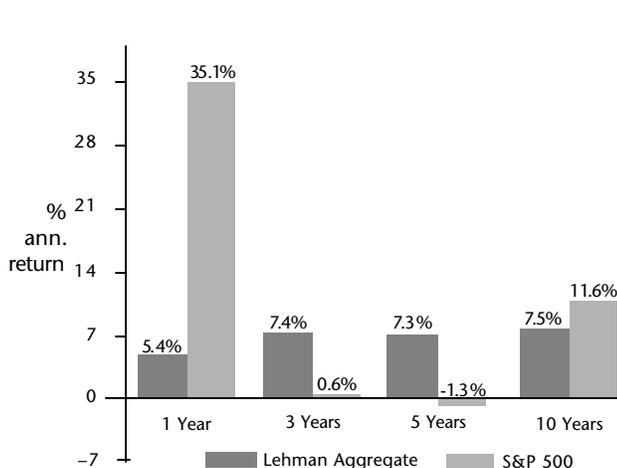
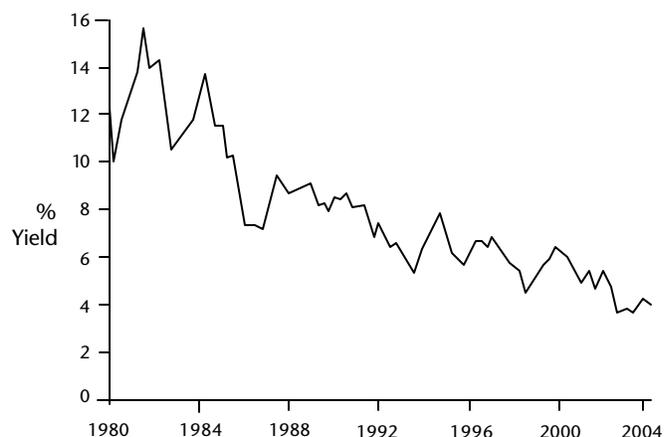


Table II. 10-Year Treasury Yield, 1980-2004



years (i.e., modest short-term rate increases, inflation subdued at 2.5% or less, and longer interest rates staying relatively stable) bonds will, at best, produce their coupon. Ten-year Treasuries should return about 4% annually, long Treasuries 4.8% to 5%, and longer term corporate bonds/mortgage-backed issues 5% to 6%. The Lehman Aggregate Index yield was 3.8% as of March 31, 2004.

However, if rates rise more sharply, on the order of 50 to 75 basis points annually over the next several years, the price declines of most bonds — short, intermediate or long — will offset their interest, resulting in negative total returns. This outlook assumes that the economic recovery continues, and the Fed eventually raises short interest rates to manage inflation expectations and the U.S. dollar's weakness. Conversely, should the economy weaken from here, bonds could do quite well, particularly relative to stocks.

A Question of Risk

CBIS chooses sub-advisers who can add relative value in any type of bond market environment; we place little emphasis on interest rate anticipation through duration management, but rather on sector decisions, yield curve positioning and issue selection. This is for good reason — there are only a

handful of managers who have succeeded by anticipating the direction of interest rates over the past twenty years. All of the many others who have tried are no longer in business!

Of course, this demonstrates the difficulty of predicting the direction of interest rates. There were many investors in 1990, for example, who planned for rising interest rates under the belief that “rates can’t go any lower.” (The 10-year Treasury Bond yielded 8%). This viewpoint may

“A key trait of successful bond managers is to know when to take risk and when not to.”

have seemed logical at the time due to inflation sensitivity and the experience of the previous 15 years, but acting on this viewpoint proved very costly.

It is important to note that a key trait of successful bond managers is to know when to take risk and when not to, and to focus upon preservation of assets and quality of the income

stream. All three of our sub-advisers — Jennison and Dodge & Cox in the Intermediate Diversified Bond Fund and Balanced Fund (IDBF), and BlackRock in the Short Bond Fund (SBF) — are very concerned with tight credit spreads, based on their belief that today’s credit spreads do not adequately compensate investors for credit risk. We find this point of view reassuring. The losses to principal possible from credit spread widening can be enormous, and can more than wipe out the excess yield achieved so far by a strategy of assuming additional risk. However, this conservative positioning may produce weak relative results over coming months, as was apparent last year in peer comparisons that were weak versus managers that sought higher yield through greater exposure to below-investment-grade issues. None-the-less, we believe that our managers are taking a very prudent and wise approach. When the bond market presents better opportunities following a period of volatility, they will have the liquidity to take advantage of the situation.

Current Positioning of CBIS Bond Funds

Short Bond Fund

BlackRock has a very unusual portfolio structure for a short bond man-

Table III. Treasury Yield Curve at March 31, 2004

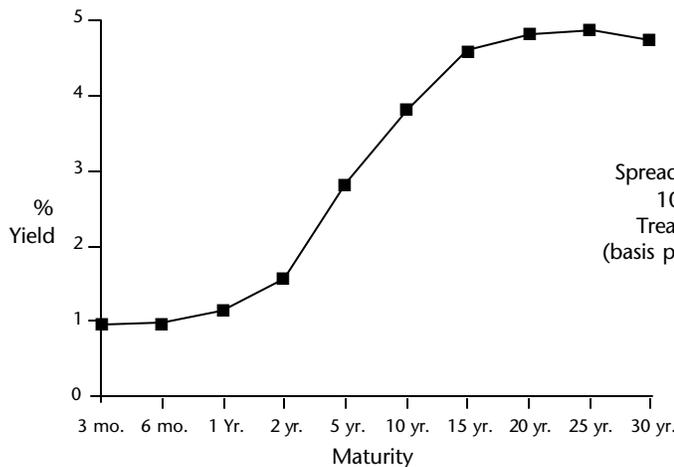
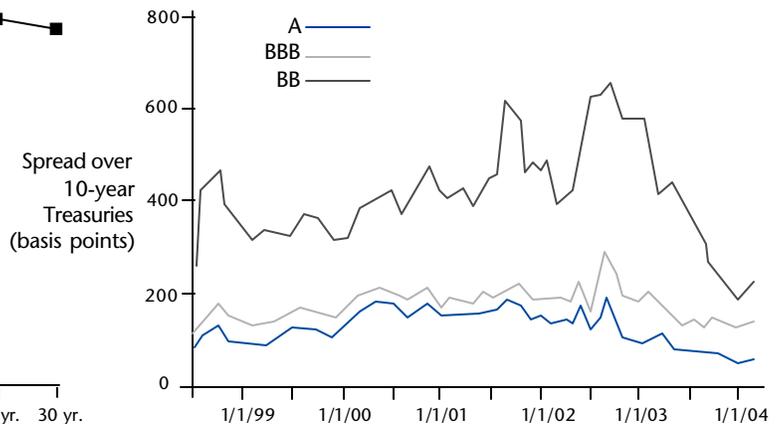


Table IV. Historical U.S. Credit Spreads



ager with an all-Treasury benchmark. The usual approach is a diversified coporate, ABS and MBS portfolio which yields 50 to 150 bp more than the two-year Treasury. BlackRock is so concerned with low spreads on shorter maturities that the portfolio is now two-thirds Treasuries; the yield is only 20 bp higher than the Index, and the portfolio duration is 0.3 yrs shorter than the benchmark, with the portfolio modestly barbelled.

*Intermediate Diversified Bond Fund
Balanced Fund*

Dodge & Cox has an effective duration about one year shorter than that of the Aggregate Index (80% of benchmark duration); this is based on their belief in the growing likelihood of inflation pressures and interest rate increases. Their successful exposure to BBB-rated corporates has been reduced, although it remains higher than that of the Aggregate Index. Due to the shorter duration, and higher stability of mortgages, the portfolio yield is 50 basis points less than that of the Aggregate.

Jennison similarly finds corporate and mortgage yield spreads relatively tight; the firm’s major strategy is a yield curve flattening posture with an extreme barbell portfolio. The emphasis on cash (actually Agency discount notes less than a year in maturity) and long duration Treasury and corporate issues, coupled with high credit quality, reduces portfolio yield to approximately 85 basis points lower than the Aggregate yield.

The large cash position in the IDBF at year-end (18.5%) is a result of the cash portion of Jennison’s barbell strategy, offsetting the longer duration Treasury and corporate issues in the portfolio (thus avoiding the one- to five-year duration segment of the yield curve, the one most subject to price loss as interest rates rise).

It is important to realize that the impact of high cash levels in a bond

portfolio is quite different from that in an equity portfolio. While cash returns can represent a serious drag on equity performance in a rising market, cash levels are factored into a bond manager’s overall duration strategy. This allows tactical yield curve positioning, and represents a tradeoff of lower cash yield for expected gains in price or via spread changes among longer duration issues.

Positioning for Rising Rates

Participants may be considering any of a number of common strategies for dealing with interest rate risk in their bond portfolios. We caution, however,

“CBIS chooses sub-advisors who can add relative value in any type of bond market environment.”

that each of these strategies comes with drawbacks that may result in sub-optimal performance compared with our actively managed bond funds.

1. Shortening Duration

If interest rates rise, a portfolio benchmarked to the Intermediate Lehman Aggregate or Gov’t/Corp Index (one year to two years shorter in duration), rather than the Lehman Aggregate Index, will clearly minimize some of the price damage. However, the yield loss from such a change in strategy is 30 to 50 basis points annually. If interest rates were to stay within a trading range for several years, the cumulative cost could be substantial. A more immediate concern is that

these, or even shorter benchmarks, expose more of the portfolio to the area of the yield curve that will suffer the largest price impact if interest rates rise sharply, as the yield curve reshapes to more typical steepness. While this strategy might have made sense in past periods, it is not nearly so attractive a hedge today. This is why use of our RCT Short Bond Fund as a hedge on long bond exposure is not ideal.

Another point that investors often overlook is that good manager decisions on sectors, spreads, and issues are more generously rewarded in longer duration portfolios (price change is driven by yield/spread change times duration). What investors may gain in principal preservation is partially offset by lower alpha (manager added-value). This is another important consideration in a low-return environment.

2. Laddering

Investors may consider laddering for two reasons: 1) the savings on manager fees by creating an unmanaged buy and hold laddered structure, and 2) laddering to shorten duration (i.e., a portion of the principal is maturing each year, available to be reinvested at higher interest rates).

CBIS believes that our active managers can produce value net of fees, and laddering is not without cost — both at a custodian and broker, and in view of the time involved for the participant or representative to periodically reinvest. Laddering solely with Treasuries or AAA/AA-rated securities will miss the opportunity to add 25 to 50 basis points in additional yield from mortgage, corporate and other issues. On the other hand, to take more credit or volatility risk in the laddered portfolio would then subject the portfolio to credit or event risk. Laddering is an “active process” — it simply moves oversight from an expe-

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rienced professional to a lesser skilled manager.

Even with laddering, the participant will still have to make a duration decision; every bond portfolio has an overall duration. If shorter, the portfolio will have a lower yield, the return will compound at a slower rate, and this will be a sub-optimal means of meeting one important goal of bonds in a longer-term portfolio, generating high and stable income. If interest rates do not rise, and either fall further or stay essentially the same, the participant will have to live with less interest than can be achieved at the higher yields available with today's yield curve. The greatest risks remain the unusual shape of the yield curve, and the price risk inherent in the short end of the curve. CBIS does not believe that a laddering strategy is the optimal way to contend with these risks.

3. Taking on Credit Risk

Introducing below-investment-grade debt into a bond portfolio theoretically expands the bond opportunity set, and may add alpha. And, as it tends to be of shorter duration (lower quality companies have to issue shorter maturities, and the higher coupon shortens portfolio duration further), it is sometimes seen as a way to hedge against rising interest rates. The problem, however, is that adding below-investment-grade debt introduces equity-like risk into the portfolio. In periods of economic weakness, it jeopardizes the income stream from bonds. As Table V points out, BBB-rated debt has been just as advantageous as high-yield debt over recent years. With corporate spreads very tight (the Merrill Lynch High-Yield Index now yields only 3.8% more than the ten-year Treasury), this will likely prove to be an unfortunate choice to shorten portfolio duration, in our view.

4. TIPS

Treasury Inflation Protected Securities (TIPS) are often cited as a means of hedging traditional bonds

Table V. Comparative Total Returns through March 31, 2004

	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
Lehman Aggregate Index	7.4%	7.3%	7.5%
Lehman BBB-rated Index	9.2%	7.7%	8.2%
Merrill Lynch High Yield Index	8.8%	5.7%	7.7%

against rising interest rates. While TIPS do have advantages in an inflationary environment, and liquidity is much improved over recent years due to heavy Treasury issuance, their use is not as simple as it seems. Interest rates can increase for multiple reasons independent of inflation. A major variable impacting interest rates is the change in the real interest rate, which is governed by changes in such factors as the cost of capital, productivity growth and overall economic growth.

“Our advice to participants who wish to hedge bond exposure against possible rising rates is to employ the new CUIT Market Neutral program.”

The stated yield of TIPS (currently 1.7% at the ten-year maturity) is the real yield; subtracting this from the current nominal yield of the ten-year Treasury (4.2%) implies a breakeven inflation rate of 2.5%. That is, if inflation exceeds 2.5% over ten years, the TIP will outperform the nominal Treasury. The CPI, over the twelve months ending February 29, rose 1.9%; the difference can be viewed as the cost of the option the TIPS buyer holds to offset potential inflation.

When real interest rates change, TIPS behave like long duration bonds (with a very low coupon compared to

nominal Treasuries). If interest rates rise, and real rates rise as well, it is difficult to predict how TIPS will perform. In 2002, real yields fell significantly and TIPS performed very well, although inflation essentially fell. The U.K. and Canadian inflation-linked debt markets have existed far longer than the U.S. TIPS market, and these foreign markets have demonstrated that such bonds behave quite erratically, not reacting as traditional bonds would to interest rate change. Thus while TIPS make sense as an inflation hedge, they could be far less successful as an interest rate hedge.

Conclusion

- Our bond programs are designed to match a participant's long-term needs for dependable income, a hedge on equity exposure and as an additional source of added-value through active management. These goals remain viable regardless of interest rate direction.
- We have some limited capability to manage duration in the SBF and IDBF. While Jennison is duration neutral, both Dodge & Cox and BlackRock will manage duration within 20% to 25% of benchmark duration.
- Our current advice to participants who wish to hedge bond exposure against possible rising interest rates is to employ the new market neutral program — “Treasury Bills plus” in structure.

SRI and Fund Performance

Interested in how our SRI program impacts fund performance? See our web site, www.cbisonline.com, for information about our new study.

A Market Neutral Primer: The Ethics of Short Selling

Prior to approving the new CUIT Market Neutral strategy, the CUIT Board of Trustees spent considerable time discussing the appropriateness of selling equities short. Short selling is a significant departure from the long-only strategies utilized in other CUIT funds. The CUIT Board considered a number of issues before ultimately approving the use of short selling in the new CUIT Market Neutral Fund.

Catholic Doctrine

First, the Board considered whether a strategy of short selling was prohibited by the Code of Canon Law. The Board's review of the Code uncovered no apparent conflict with the use of short selling within a traditional investment program. Specifically, the application of short selling in a market neutral program appeared to complement the standard of exercising vigilance to protect assets stated within the Code.

Investing vs. Speculating

The Board also reviewed the issue of short selling as an investment process, as opposed to its use as a speculative technique. The market neutral approach considered for use in the CUIT Market Neutral Fund is designed to have tightly controlled long and short portfolios, each complementing the other as closely as possible to eliminate stock market exposure. The goals are risk reduction, removal of market volatility, and the capturing of the stock selection ability of each market neutral manager. Such an approach allows a participant to reduce risk and volatility within a total portfolio of stock and bond investments, and encourages a long-term view of the return potential of the overall portfolio. The Board viewed the CUIT Market Neutral Fund's approach as an investment strategy, rather than a specula-

tive strategy, because short selling is used to capture the value inherent in periodic individual company mispricing in the market rather than to profit from the long-term decline of a company in distress. Short selling employed solely to profit from a company's long-term decline involves assuming a net short position, unbalanced by a corresponding long position. It has a far more speculative character, exposing an investor to the asymmetrical risk of pure short selling. Stocks can fall only to a price of zero; the most a long investor has to lose is the value of the initial invest-

“Short selling, like long investing, is an investment process. Either can be used in an ethical fashion, or for ends that we, as ethically concerned investors, would not condone.”

ment. But stocks can rise multiple times in value; the potential loss from a speculative short position is many times the value of the investment.

A Question of Intent

The CUIT Board finally considered whether short selling could be somehow detrimental to a company's business and to its employees, shareholders and other stakeholders. The staff of CBIS pointed out that short selling is just an investment process, as is long-only investing. Either can be used in an ethical fashion, or for ends that we, as ethically concerned

investors, would not condone. For example, assuming a substantial short position in a company and then disparaging that company in the financial press by innuendo would obviously be unethical. Similarly, a practice that was common during the 1980s involved taking a substantial long position in a company's stock (called strategic block investing) with the goal of firing management, selling off assets, and laying off substantial numbers of employees, all in order to inflate company profits and boost the company's stock value, benefiting the strategic investors at the expense of other corporate stakeholders. Clearly, this a case of long-only investing that appears unethical from our viewpoint. However, when stock positions are shorted to capture market inefficiencies in pricing — efficiencies that regularly exists even among even the best and strongest companies — or when long positions are taken to capture the long-term benefits of a rising economy and improving company prospects, these seem to be reasonable, ethical investment processes.

A Beneficial Strategy

The concept of short selling is a new one for CBIS participants, and not always an easy one to grasp. However, we believe that the benefits of a market neutral strategy support its addition to our group of equity funds, and that it can contribute to better portfolio results with lower volatility and risk. Managing a combination of long and short portfolios is more complex than overseeing a traditional long-only portfolio. CBIS has spent considerable time identifying sub-advisors who have demonstrated such an ability, and who have produced the results that we require for our new CUIT Market Neutral Fund. ■



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ANNOUNCEMENTS

■ **CBIS Makes Changes to Board of Directors**

Effective February 20th, Raoul L. Carroll, who has served on the CBIS Board of Directors since February of 1996, was named Chairman of the Board. Brother Damian Steger, who has been Chairman of the Board since 1997, and a board member since 1992, will remain a member of the board. In addition, Kathleen Almaney has joined the CBIS Board of Directors. Biographies of each board member can be found at <http://www.cbisonline.com/about/board.asp>.

■ **Shareholder Advocacy Directory Added to CBIS Website**

The new Shareholder Advocacy Directory enables visitors to search and view up-to-date descriptions of CBIS SRI activities by company and issue, the text and vote totals of shareholder resolutions, educational reports on SRI issues of concern to participants and the role of shareholders in addressing those concerns. To view, click the Shareholder Advocacy Directory link in the left margin of the CBIS home page.

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