

PRINCIPLES

An Investment Newsletter



JULY 2004

The CBIS Investment Process *Manager Selection, Evaluation, Retention/Replacement*

H I G H L I G H T S

■ As a “manager of managers”, CBIS’ investment process consists of 1) manager selection, 2) monitoring and evaluation, and 3) retention or replacement.

■ Our approach to manager selection is guided by our investment philosophy. We invest for the long term and believe that investments in high quality securities best achieve our clients’ objectives. We do not attempt to chase speculative surges in lower quality securities.

■ We seek out managers who demonstrate a credible investment process that can add value over a complete market cycle. We evaluate managers based on their results over a complete market cycle.

■ After a manager is hired we follow a rigorous, systematic process for ongoing monitoring and evaluation. The process includes quantitative and qualitative criteria that ensure the retention/replacement decision is made rationally and analytically, not emotionally.

■ The decision to retain or replace an underperforming manager reflects judgment based on quantitative and qualitative analysis, our analysis of the reasons for underperformance, and our confidence in the manager’s ability to recover lost ground and achieve our targeted long-term return.

Introduction

As a “manager of managers”, Christian Brothers Investment Services (CBIS) hires institutional investment management firms to manage our institutional funds and separately managed portfolios. Our SRI program is an overlay on our managers’ investment programs. Our investment process, therefore, consists of the selection, evaluation and, if need be, the replacement of the investment managers we hire.

This article provides an overview of our process. Because the process is multifaceted and complex, we encourage all participants who wish to learn more about it to contact your CBIS Investment Advisor. He or she can also coordinate a discussion directly with our investment advisory services staff. Our investment staff is totally dedicated to this area, and enjoys the opportunity to discuss the topic with you, and to answer your specific questions. The overview presented here is intended to provide a foundation for such a discussion.

The CBIS Investment Philosophy

Our overall approach to hiring and managing our managers is guided by our investment philosophy. We believe that investment in high quality securities best captures the performance of a targeted asset class, and best achieves our clients’ long-term investment objectives. We do not

attempt to chase the periodic speculative surges of low quality securities, where performance reversals are generally swift and severe. Over the longer term, investors often give back more than they gain, and end up reducing, not augmenting, their long-term returns. We emphasize low turnover and bottom-up security selection driven by fundamental research. (The single exception to this is our Index Fund, where we seek to replicate the performance of the S&P 500.) We typically combine two or more managers in our funds in order to reduce the volatility of manager value added over the benchmark, and we evaluate fund and manager performance over an entire market cycle (generally 3 to 5 years). We believe in hiring good managers and giving them the time to apply their investment process to produce our desired results.

Investment Program Goals

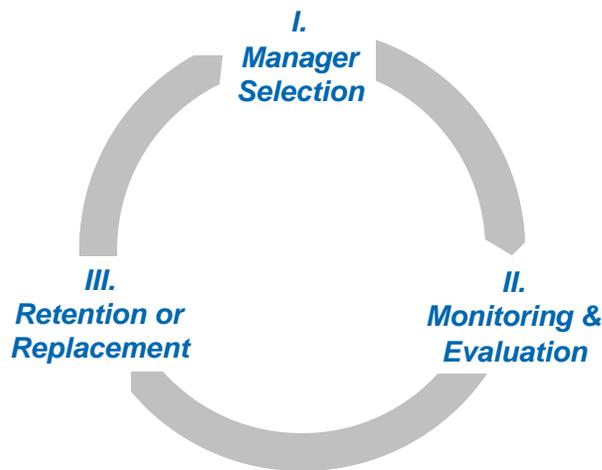
We seek to add value over the benchmark at both the manager and the

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Figure 1. The CBIS Investment Process



fund level. With a fund, we try to exceed the benchmark and the median peer group return over a three-year period, and to exceed the benchmark and to rank in the top quartile of the peer group over a five-year period. Our goals for manager value added, net of fees, are as follows:

Asset Class (Targeted Value Added)

Large Cap Value Equity (100 b.p.)
 Large Cap Growth Equity (100 b.p.)
 International Equity (200 b.p.)
 Small Cap Equity (200 b.p.)
 Intermediate Bond (50 b.p.)
 Short Bond (25 b.p.)

Our selection and evaluation of investment managers is designed to support the achievement of the following objectives:

- a diversified investment program
- long-term investment perspective
- optimization of the risk/return tradeoff across asset classes and within asset management styles
- complementary multiple manager teams for each investment program.

The CBIS Investment Process

As shown in Figure 1, CBIS' investment process consists of three basic

stages, 1) manager selection, 2) monitoring and evaluation, and, based on the manager's results, 3) retention or replacement. The circular figure points out that this process is dynamic. We constantly review our managers, continuously research new managers (in order to maintain a short list for each style in the event replacement is required), and hone our analytical framework for selecting managers who can succeed over the long term.

I. Manager Selection

CBIS seeks out a number of identifiable characteristics in the managers we hire in order to ensure that they are a good fit with our overall investment philosophy, and to gain our required comfort level in their ability to meet our expectations for value added over a market cycle.

An emphasis on fundamental research. The manager's investment process should be driven primarily by rigorous original fundamental research of securities and sectors.

A strong 3- to 5-year track record. While a strong track record does not guarantee superior performance going forward, it is an important indication that a manager has an effective strategy for creating value added over the benchmark.

An understandable, sustainable investment process. The manager's approach to achieving value added should be clear and transparent. We must also be able to satisfy ourselves that the process is repeatable and that it will be rewarded over the course of an entire market cycle.

Continuity of personnel. The investment team responsible for the manager's historical track record should demonstrate a cohesiveness and continuity of personnel over time. We expect the team to remain together after the manager is hired.

Interests aligned with those of investors. We look for evidence that the manager's interests are aligned with ours. We prefer independent firms in which principals have ownership interests.

Suitability for our version of SRI. While our stock screens are limited in scope (only 5% of the S&P 500 is currently restricted from CBIS portfolios) we must be comfortable that a manager's investment program is not over-reliant on investment in restricted stocks or sectors. This may compromise the managers' ability to add value going forward.

Complementary investment approaches. Each manager we review for hire should be capable of producing the long-term results we seek, yet because we pair managers, we also look for a low correlation of added value. As we examine the investment processes being used, they should be clearly differentiated, working well at different times. We hope to achieve the average of the two managers' returns over time, but we expect better than average volatility of the managers' returns. We will generally see this result when we plot a 50/50 historical combination of those two managers.

A Team Approach

CBIS applies a team approach at all stages of the manager selection process. An Investment Team, composed of senior investment profes-

Table 1. Monitoring and Evaluation Time Line

Under Review				On Watch	
Successive Underperformance For:				Annualized Underperformance For:	
<i>1 Quarter:</i>	<i>2 Quarters:</i>	<i>3 Quarters:</i>	<i>4 Quarters:</i>	<i>1 Year:</i>	<i>2 Years or More:</i>
Phone discussion with IAS staff	Phone discussion with CIO	Face-to-face meeting (IAS staff and Manager)	Formal presentation of action plan to CBIS Management Team	Review for following 3 quarters, then recommend retention/replacement (CIO and Management Team)	Review for following 3 quarters, then recommend retention/replacement (CIO and Management Team)

sionals within the firm, meets formally to review Requests for Proposals (RFPs), meet with prospective managers and advise on all hiring and replacement decisions. The CBIS Management Team, composed of CBIS’ senior departmental managers, likewise reviews RFPs and meets with managers. All hiring decisions are made by CBIS’ Investment Advisory Services (IAS) department, but with the advice and consent of the Investment and Management Teams. Throughout the process we also draw on insights offered by an Investment Advisory Committee—a group of veteran independent investment professionals with experience at plan sponsors and investment firms who share insights with us about manager candidates under consideration, and who make suggestions as to managers we may wish to consider. Information about manager candidates is also drawn from the Wilshire Compass database, RFPs, meetings at CBIS offices, and on-site visits. Our goal is to have had multiple meetings with the principals of an investment firm prior to the RFP process.

II. Monitoring & Evaluation

Once a manager is hired, we follow a rigorous, systematic process for ongoing evaluation. This process includes:

- daily access to portfolio holdings
- daily review of portfolio performance
- monthly review of transactions
- quarterly performance attribution analysis
- ongoing meetings with manager prospects.

We have the ability to conduct a daily review of exposure to any given security if we have concerns with it, although in practice this is rarely necessary. Quarterly performance attribution analysis, however, is a critical, fundamental aspect of the monitoring process. Each manager prepares a quarterly report that shows how they achieved their added value or their underperformance, and that assesses the portfolio’s exposures to various market risks. This report helps us determine whether the manager is pursuing the strategy for which they were hired.

Meeting with managers is also critical to the monitoring process. We meet with one of our managers on a quarterly basis at CBIS’ New York office, but even more important are our visits to our manager’s offices. We believe that it is critical to meet with their staff, observe the dynamics of their decision-making process, and assess intangible factors such as corporate culture and motivation. We also

meet on a regular basis with prospective managers. This has educational value as we cross-check our managers’ investment thinking with that of their competitors, and it helps us keep an up-to-date and well-researched short list of candidates should a manager replacement be necessary.

When a Manager Underperforms

Monitoring and evaluation are most visible, of course, when a manager is underperforming. And a reality of investing is that all good managers will experience periods of underperformance when their approaches are temporarily out of favor, or when speculative surges in the market temporarily eclipse the attractiveness of a long-term, quality-oriented investment approach. Our process is structured to create a systematic and methodical framework for evaluating periods of underperformance, and for ensuring that the retention/replacement decision is made rationally and analytically, not emotionally. Our objective is to give managers in whom we can retain confidence the time to turn results around, and to replace managers when a breakdown of process or of organizational structure has occurred, where we lack confidence in their ability to recover performance in subsequent periods.

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New 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, resolutions and vote totals, educational reports on SRI issues, and the role of shareholders in addressing these concerns. To view, click the Shareholder Advocacy Directory link in the left margin of the CBIS home page.

Quantitative Thresholds. Table 1 depicts the timeline, quantitative thresholds and monitoring process that we apply when a manager underperforms. The formal process begins after one quarter of underperformance with a telephone discussion with the manager, initiated by IAS staff. If underperformance lasts for two consecutive quarters, our CIO confers with the manager by telephone. After three consecutive quarters, our CIO and staff meet in person with the manager. And if underperformance persists for a year (sequentially or annualized on a trailing four quarter basis), the CIO reports to the CBIS Management Team on the reasons for the underperformance and offers an assessment of whether results should turn around in the immediate future. Additional updates are provided at the end of each successive quarter for the next three quarters. IAS makes a recommendation as to whether to retain or replace the manager at the end of that period. Our advisory boards are updated on “under review” managers as well.

Of course, underperformance is rarely neatly sequential. More often, a weak quarter or two is followed by a quarter or two of outperformance. In these cases, we look to annualized results. If a trailing period of 2 years or more is reached when performance, on average, has lagged the benchmark, the manager is placed “on watch”, triggering the review process described above.

Qualitative Factors. The monitoring/evaluation process is based on a review of qualitative factors as much as on the triggering of quantitative thresholds. When a manager struggles, problems in the following qualitative areas may be to blame. This is not a comprehensive list, but it is representative of the types of potential problems that we look out for.

- significant change in key people
- apparent discord at firm
- lack of effective leadership
- change in ownership
- significant change in asset growth or product development
- administrative or servicing problems
- change in the investment decision making process
- evidence that a value or style discipline has been ignored
- significant change in portfolio turnover from past patterns.

Understanding these issues becomes paramount when a manager is underperforming, yet we cannot neglect our strong performers either. We get concerned, for example, if asset growth is too rapid. Will this impact the manager’s ability to execute its investment strategy? Has asset growth forced a firm to concentrate its portfolio in the most highly liquid, largest capitalization securities in its style area? This may be a problem if the manager has derived its historical value added from smaller capitalization stocks. Are demands on portfolio management staff increasing due to frequent new business presentations, diluting their time for oversight of our portfolios? Or, has a change in ownership taken place at the firm, bringing with it a change in corporate culture and reduced incentives for strong performance? This may show up initially, for example, as an increased rate of turnover in younger staff. We also monitor portfolio turnover trends. High turnover may be appropriate in a volatile market, when price targets are reached more quickly than expected, but it may also suggest an unwelcome departure from the investment process the manager was hired to execute.

In general, a manager may be doing quite well versus a benchmark, but if critical qualitative factors are under strain within a firm we become con-

cerned because this may undermine performance going forward. We would rather uncover problems up front than after the fact, when they materialize in the numbers. Our monitoring process, therefore, is as active when managers outperform as it is when they underperform.

III. Retention or Replacement

At some point we have to reach a determination: Do we retain an underperforming manager? Can the firm still meet our expectations for added value over the long term? Would we hire this manager today? There is no formula for this decision. Inevitably, it requires judgment based on our assessment of quantitative and qualitative factors, and on our conclusions about the reasons for underperformance. If we have confidence in the people at the firm, if their investment process remains intact, we can be patient. However, as time goes on, it’s harder to recoup underperformance. One way we assess this is to look back at the past. Has this firm suffered prior periods of underperformance? Has it been able to recoup underperformance in subsequent periods? If so, this influences our thinking. A large-cap manager termination can cost 0.5% to 1% in total return, and a small-cap or international manager change can run 2% or more. If we have to make a change, we try to mitigate these costs by using a transition manager. Changing managers is costly. None the less, we are prepared to do it when our best judgment argues for it. ■

Visit the CBIS website to access the audio recording and written transcript of the June 9th Participant Conference Call on CBIS’ Manager Selection Process.

Market Neutral Primer: Investing in a Low Return Market Environment

by Frank Haines, Chief Investment Officer

"A Dose of Reality"

Institutional investors these days seem to be torn between two alternative methods of addressing expected equity and bond market returns. On the one hand, many of the largest investors—overseeing pensions, endowments and foundations, for example—expect lower market returns in the years ahead than we experienced during the 1990s and during 2003, but seek to augment their portfolio's returns by the use of alternative (non-traditional) investing strategies. Rather than substantially reduce their investment goals, from 10% or more annually to 5% or 6%, these large investors plan to utilize sizeable allocations to alternative investments such as hedge funds, venture capital, and distressed debt in order to augment returns. Indeed, there has been a surge of interest in alternatives over the past five years; hedge fund capital has increased ten-fold since 1990 to an estimated \$900 billion.

This is an interesting approach to the problem, but I expect that it is one that will ultimately lead to great disappointment for the majority of these investors. Many alternative strategies have produced compelling performance historically, but the market conditions that supported this performance have disappeared. Looking out through the end of the current decade, there will likely be no more multi-year periods of double-digit equity returns, no secular decline in

interest rate yields and credit spreads, no likelihood of cheaply financed leverage from low short term interest rates; all of these factors contributed to the substantial returns of alternatives over recent years.

Moreover, when investment approaches that function well at a

Lowering return expectations does not mean throwing in the towel. It does, however, encourage taking advantage of every effective means available to augment returns.

small scale (such as within a hedge fund structure) attract too much money, it is often the managers who often gain the most. The asymmetric structure of hedge fund fees can lead those managers to take excessive risks and utilize leverage in order to meet investors' high return expectations. When performance is strong, these managers profit handsomely by virtue of incentive fees which run up to 20% of annual profits. If performance is mediocre, the manager still earns

their management fee. But if their strategies backfire and performance is poor, they can simply close down the fund, return the investor's capital, and start over with a new fund. This situation offers an interesting parallel with the negative aspects of options as a form of corporate compensation.

The second method available to investors for addressing expected performance is a far less popular one—adjusting their investment objectives downward based on lower market return expectations. Clearly it is difficult to lower an institution's investment goal from a 10% annual return to a 5% or 6% return, especially if spending is running at 5% or more. But I believe that it will be more palatable to be surprised on the upside after lowering expectations, than disappointed by failing to meet unrealistic goals.

Contending with Leaner Returns

Lowering expectations does not mean throwing in the towel. It does, however, encourage taking advantage of every effective means available to augment lean market returns. Some of these techniques that will benefit participants in a lower return environment are:

- achieving added return net of investment costs from active management;

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SAVE A TREE! SIGN UP FOR *E-DELIVERY*.

Do you know that it takes an entire tree to make approximately 8,000 sheets of paper, and that 500 sheets use 6% of a tree? In 2003, to help save trees and to improve our own environmental stewardship, we launched the CBIS *E-Delivery* program. *E-Delivery* offers email delivery of all CBIS communications, and access to account information online. *E-Delivery* is faster than regular mail, and it benefits the environment by reducing paper usage. If you haven't done so already, please sign up for CBIS *E-Delivery*, and help save a tree. To register, contact your Investment Advisor or a member of the CBIS Participant Services Team at (800) 321-7194, or sign up at our website (www.cbisonline.com/edelivery).

- controlling portfolio turnover and execution costs;
- rebalancing effectively to take advantage of asset volatility; and,
- seeking sensible, higher alpha strategies.

CBIS focuses continuously on manager oversight and on trying to identify managers that can meet value-added expectations, as well as on controlling fees and turnover in our manager's portfolios. In an earlier *Principles* article (October 2003), we reviewed the benefits of structured rebalancing to take advantage of periodic market volatility. I would like to comment on the remaining two techniques—briefly on execution costs and more extensively on higher alpha programs.

Reduced Execution Costs

By the end of the year, we will have completed a survey of each of our equity and fixed income manager's trading practices and trading costs. Aside from reviewing each manager's attentiveness to SEC and AIMR guidelines for effective trading oversight, we have monitored their progress on commission reduction, measurement of actual trade execution vs. market measures, and whether or not there has been increased use of electronic trading methods over recent years. With lower expected returns, every basis point that can be saved due to effective trading is valuable to our participants.

CBIS Market Neutral: A Conservative Approach to Higher Alpha

Among other features, CBIS' introduction of the CUIT Market Neutral Fund is meant to provide a higher value-added (i.e., higher alpha) strategy to the CBIS fund line-up. The Fund's objective is to produce consistent positive returns over a three- to five-year cycle, with little correlation to stock or bond returns and with a low level of volatility. The Fund's return results from a combina-

tion of the short-term yield on cash (likely to rise over coming years) plus a targeted value-added component (before fees) of 3% to 4% from active stock selection. Net of fees, the resulting alpha of 1.5% to 2.5% is considerably higher than what can usually be achieved through traditional equity or bond investing. Aside from providing higher alpha, we believe that the CUIT Market Neutral Fund will serve as an effective hedge on bond portfolio risk from rising short-term rates, while additionally reducing overall portfolio volatility and downside risk.

Aside from providing higher alpha, we believe that the CUIT Market Neutral Fund will serve as an effective hedge on bond portfolio risk from rising short-term rates, while additionally reducing overall portfolio volatility and downside risk.

Addressing Participants' Concerns

Our discussions with participants have revealed some concerns about market neutral investing, some of which reflect a misunderstanding of CBIS' strategy.

"We aren't comfortable investing in hedge funds." Hedge programs typically have these common characteristics: use of leverage to multiply asset returns, short selling to hedge a portion of market risk, an incentive fee structure, limited access for withdrawals, and investment in complex or less liquid securities.

The CUIT Market Neutral Fund, in contrast, is not a hedge fund product. While the Fund will use short selling, it will do so only to offset long portfolio positions in order to remove exposure to overall equity market risk. The managers of the Fund will not employ leverage to augment returns. Participants can invest and withdraw their funds daily, as the portfolios are composed of liquid, fully marketable large- and mid-cap stocks. Finally, the Fund will have a flat fee; no incentive is paid to the managers, thus any gains accrue wholly to our participants who are invested in the Fund.

"This program appears to be too risky."

There are many products labeled as market neutral that comprise multiple strategies beyond long/short equity portfolios; for example, arbitrage positions, distressed debt approaches, convertible bond strategies, etc. These are often packaged in a fund-of-funds structure to reduce risk by combining several, low correlation strategies in one fund. We purposely chose only quantitative long/short equity strategies for the CUIT Market Neutral Fund in order to make the risk of the program suitable for very conservative investors, and to make our program as clearly defined and understandable as possible while enabling daily liquidity for Fund investors. While fund-of-fund approaches may offer the perception of lower risk, in part due to the larger number of strategies, the historically low correlation among such strategies can disappear during periods of global market illiquidity or high volatility as we witnessed during the summer of 1998. When this occurs, results can differ sharply from investor expectations. We are confident that our approach avoids the illiquidity risk that has plagued some market neutral programs in the past.

"The fees for this product are very high." The anticipated total cost for the

Fund will be about 1.5% at inception, although this will gradually decline to 1.4% with growth of assets. The fee level results primarily from the fact that each manager in the Market Neutral Fund manages two portfolios, and must constantly monitor and adjust positions in order to maintain market neutrality. This is far more complex than overseeing a long-only stock portfolio. In relation to most alternative investment products our Fund is attractively priced. Hedge funds commonly charge a 1% to 2% management fee plus up to 20% of annual profits as an incentive fee. By comparison, the Market Neutral Fund's flat fee is modest, and is a unique, compelling feature of the program if the Fund exceeds its benchmark return (Treasury Bills plus 3.5%).

"There is so much money being directed at such products that returns will prove disappointing." This is a valid concern regarding many alternative strategies, such as venture capital and hedge

While the extraordinary returns of the 1980s and 1990s are behind us, and future expectations appear a bit bleaker, participants can still utilize a number of methods to improve their probabilities for investment success.

funds, in particular. Any strategy that derives its gains from less liquid securities, from momentum investing, or that is not compatible with substantial asset growth (not "scalable") may disappoint investors who base return expectations on past results.

The market neutral strategy within

our Fund is scalable, i.e., it should be able to absorb a substantial amount of assets without diluting return expectations. This results from its emphasis on highly liquid and actively traded larger capitalization stocks, and the ability to avoid harder-to-borrow issues for shorting. Also, the investment approaches of the managers within the Fund differ. In general, there are a wide range of quantitative long/short equity approaches, so it is unlikely that numerous managers are pursuing the same stocks for long or short positions.

There is never a easy time for managing investments—decisions always appear easy only with the benefit of hindsight. While the extraordinary returns of the 1980s and 1990s are behind us, and future expectations appear a bit bleaker, participants can still utilize a number of methods to improve their probabilities for investment success. CBIS is focused on contributing to that success by every prudent means possible. ■

Market Neutral FAQs

Q: Could you discuss how you will implement your SRI screens in this fund?

A: Each of our managers has the ability to screen out securities at their trading desk. We will provide the managers with a list of screened securities from our SRI department. They will load those securities by CUSIP number into their trading systems, and not purchase them in either our long or short portfolios.

A feature that we have with our custodian, Mellon, is the ability to track positions daily. Mellon will alert us to the purchase of any restricted security should it occur in our portfolios. However, the likelihood of that happening is very low. Generally, the technology used by our manager's

trading desks is sufficient to screen out these securities.

Q: Why hasn't CBIS incorporated other lower correlated strategies into the fund as is common in many fund of fund structures, such as convertible bond arbitrage, or some other risk arbitrage strategy?

A: As this fund represents many of our participants' first foray into alternatives, we want to ensure that we meet their expectations and incorporate risks that are understandable to the greatest extent possible. As a result, we did not want to add extraneous risks, such as credit risk, liquidity risk and others.

Some of these risks were all too apparent in 1998, and we are not con-

vinced that some of the relatively short data series that demonstrate low correlations would be a sound rationale for incorporating these sort of structures.

Many of these structures, as well, utilize incentive fees, may not offer separate accounts, and thus couldn't incorporate our Principled Purchasing restrictions. So that's another disqualifier. We did look at two diversifying strategies beyond quantitative equity approaches when we reviewed candidate managers for this fund. We looked at the statistical arbitrage and pairs trading firms. We were somewhat concerned that these strategies would not produce the required alpha we were looking for, and we found the pairs results too episodic.



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ANNOUNCEMENTS

As you plan your September schedules, keep in mind these upcoming dates and events.

■ **Participant Conference Call: Wednesday, September 15, 2004 at 2:00 P.M.**

We encourage all participants to join our next CBIS Participant Conference Call, to be held on Wednesday, September 15, 2004 at 2:00 P.M. Eastern Time. The CBIS Participant Conference Call program provides an opportunity to pose questions directly to CBIS' senior staff in the live Q&A portion of the call. Emailed questions will also be answered during the Q&A period. The subject of the September 15 call is CBIS' SRI program. We'll announce the specific topic during August.

■ **CBIS to Appear at September 2004 DFMC Conference**

CBIS will be attending and exhibiting at the Diocesan Fiscal Management Conference (DFMC) in Chicago from Saturday, September 25 through Monday, September 27, 2004. We hope to see you there.

Contacting CBIS *Your CBIS Investment Advisor is ready to assist you.*

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